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Disclosure by Issuers of Municipal Securities: An Analysis of Recent Proposals and a Suggested Approach

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NOTE

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I. INTRODUCTION

After years of exemption from regulation under the securities laws[1] and exposure to liability only under the antifraud provisions of these laws,[2] participants in the offer and sale of municipal securities[3] have attracted increased federal attention since Congress began considering federal regulation of municipal securities in 1974. This trend has been preceded by scattered decisions[4] and SEC actions[5] and by state regulatory efforts[6] impacting on participants in the public finance industry.[7] Allegations of widespread fraud among brokers and dealers of municipal securities served as the catalyst for federal action that culminated in the Securities Acts Amendments of 1975.[8] Under these amendments "municipal securities dealers" are regulated under new section 15B of the Securities Exchange Act of 1934.[9] The amendments also established the Municipal Securities

1. Securities Act of 1933 § 3(a)(2) [hereinafter cited as the 1933 Act], 15 U.S.C. § 77c(a)(2) (1970); Securities Exchange Act of 1934, § 3(a)(12) [hereinafter cited as the 1934 Act], 15 U.S.C. § 78c(a)(12) (1970). "Regulation" under the 1934 Act, as used in this Note, is to be distinguished from 1933 Act registration requirements and from the antifraud provisions of both Acts.

2. 1933 Act § 17(a), 15 U.S.C. § 77q(a) (1970); 1934 Act §§ 10(b), 15(c), 15 U.S.C. §§ 78j(b), 78a(c) (1970), and Rules 10b-5 and 15c1-2 promulgated thereunder.

3. "Municipal securities" for purposes of this Note are defined as the term is defined in § 3(a)(2) of the 1934 Act, 15 U.S.C.A. § 78c(a)(2) (Supp. 1976):

> [S]ecurities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States; or any security which is an industrial development bond. . . .

4. *See* Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955) (underwriters of governmental securities could be held liable under general antifraud provisions (§ 17(a) of the 1933 Act, 15 U.S.C. § 77q(a)(1970), and § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970)) despite 1933 Act § 12(2), 15 U.S.C. § 771(2) (1970), exemptions for negligent misstatements and omissions, but liability must be based on "knowing or intentional" misrepresentation); Doty, *Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel*, 15 B.C. IND. & COM. L. REV. 393, 415-20 (1975) [hereinafter cited as Doty, *Antifraud*].

5. *See In re* Walston & Co., Securities Exchange Act Release No. 8165, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474 (SEC disciplinary action against underwriter for failure to make "diligent inquiry, investigation, and disclosure" of material information in sales literature); Doty, *Antifraud*, *supra* note 4, at 413.

6. *See, e.g.*, Tennessee Municipal Securities Act of 1972, TENN. CODE ANN. § 9-1401 (1973 Repl. Vol.), repealed by Tennessee Public Acts, ch. 506 (1976).

7. The term "public finance industry," for purposes of this Note, is used interchangeably with "municipal securities industry" and refers to all participants and transactions involved in the offer and sale of municipal securities.

8. Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered sections of 15 U.S.C. § 78). These amendments are discussed in Part II.B. *infra*.

9. 1934 Act § 15B(a)-(c), 15 U.S.C.A. § 78o-4(a)-(c) (Supp. 1976). The SEC's direct rulemaking authority with respect to municipal securities transactions is limited to control

Rulemaking Board (MSRB)[10] and vested it with authority to promulgate rules for the municipal securities industry.[11]

Noteworthy in the realm of issuer regulation is the express proscription found in amended section 15B(d)(1) of the 1934 Act:

> Neither the Commission [SEC] nor the Board [MSRB], is authorized under this title, by rule or regulation, to require any *issuer* of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.[12]

That proscription was added in the "Tower amendment,"[13] which was adopted to clarify the continued total exemption of municipal securities issuers from all but the antifraud provisions of the securities laws.[14] The rationale for this continued exemption, along with restrictions on the applicability of certain provisions of the securities laws to municipal securities dealers, is set forth in Senate Report Number 94-75, which cautions that regulation of the municipal securities industry must "take into account the uniqueness of the industry and its distinctions from the corporate securities industry."[15]

Notwithstanding the "uniqueness of the industry," delicate notions of federalism and comity, and widespread disagreement over permissible and practical degrees of federal regulations, various circumstances described below have convinced federal officials, congressmen, and commentators that issuers of municipal securities should be subject to some form of federal regulation or direction regarding disclosure of material information concerning the issue and issuer. Two bills have been introduced in each house of Con-

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of fraudulent, manipulative, and deceptive acts and practices. See S. REP. No. 94-75, 94th Cong., 1st Sess. (1975).

10. 1934 Act § 15B(1), 15 U.S.C.A. § 78o-4(b)(1) (Supp. 1976); *see* note 42 *infra* and accompanying text.

11. 1934 Act § 15B(b)(2), 15 U.S.C.A. § 78o-4(b)(2) (Supp. 1976). *See* Dikeman, *The Municipal Securities Rulemaking Board: A New Concept of Self-Regulation*, 29 VAND. L. REV. 903, 922 (1976); note 32 *infra*.

12. 1934 Act § 15B(d)(1), 15 U.S.C.A. § 78o-4(d)(1) (Supp. 1976) (emphasis added).

13. *See* S. REP. No. 94-75, *supra* note 9, at 478.

14. Interestingly, a municipal securities issuer was not clearly amenable to suit under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970), until "person" was redefined in § 3(a)(9) of that Act to include a "government or political subdivision, agency, or instrumentality of government," 15 U.S.C.A. § 78c(a)(9) (Supp. 1976). The 1933 Act definition of "person" previously had included a "government or political subdivision thereof" (§ 2(2), 15 U.S.C. § 77b(2) (1970)), but the general antifraud provision of that Act, § 17(a), 15 U.S.C. § 77q(a) (1970), has not uniformly been held to imply a private right of action. For sovereign immunity questions involved in suits against issuers see Part IV *infra*.

15. S. REP. No. 94-75, *supra* note 9.

gress to effect such regulation.[16] Three of the bills are similar and simply bring issuers of municipal securities within the current regulatory framework of the 1933 Act and the 1934 Act.[17] The "Municipal Securities Full Disclosure Act of 1976," as the Williams-Tower Bill (S. 2969) is entitled, takes a different approach and would subject municipal issuers to limited federal regulation through the 1934 Act only.[18]

The proposed federal bills have ignited controversy among those interested in the public finance industry. Many critics feel that neither federal nor state regulation of disclosure is warranted. Others maintain that if there is to be regulation, it is the province of the states to regulate matters dealing with state and local finance. Proponents of federal regulation, on the other hand, argue that federal intervention is supportable by the dependence and effect of the municipal securities markets on interstate commerce and by a strong national interest in an effective and efficient municipal securities market. The proponents of federal regulation disagree, however, over the means and degree of regulation that is desirable. This Note explores the circumstances that have sparked this renewed interest in the need for regulation, the means now available to accomplish some level of control, and the private sector's efforts to achieve the desired disclosure without governmental regulation. The problems of sovereignty and federalism raised by federal intervention are analyzed in some detail. Also discussed are the various proposals that have been made in Congress and by commentators, with primary focus on several statements submitted to the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs in connection with hearings held on the Eagleton and Williams-Tower Bills February 23 through 25, 1976.[19] Finally, recommendations and alternatives are proposed in light of the circumstances, competing considerations, and proposals discussed in Part III of this Note.

II. Background

A. *The Original Municipal Securities Exemptions*

The legislative history of the 1933 Act[20] is not expansive on the

16. S. 2969; S. 2574; H.R. 11535; H.R. 11044; *see* Part III.B. *infra*.

17. *See* Part III.B.(1) *infra*.

18. *See* Part III.B.(2) *infra*.

19. S. 2574 and S. 2969, respectively, discussed in Part III.C. *infra*.

20. For a thorough commentary on the legislative history, see Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959); *see* Note, *Municipal*

rationale for the municipal securities exemption from that Act. Commentators have suggested, and those who participated in the enactment have confirmed,[21] that the primary explanation for the exemption was the relatively minor and fraud-free role played by municipal issues in the securities markets at that time coupled with the pressing problems of private sector securities fraud and the potentially derailing effects of an attempt to regulate state and local finance. The testimony in the House and Senate on the subject reflects this explanation, and also suggests considerable confidence in the trustworthiness of state securities.[22]

Unlike the 1933 Act, the original bill that became the 1934 Act contained no exemption for municipal securities. The predictable result was considerable industry testimony and congressional debate seeking to amend the bill.[23] Those who favored exemption argued that the original bill would severely burden the public finance industry through unrealistic capital requirements for writers, potentially disastrous separation of broker and dealer functions, dealer commitment limitations that failed to consider the bidding process, and possible costly independent audits of municipal issuers.[24] In addition, proponents of exemption offered various policy arguments for their position,[25] including the protective effects of voluntary compliance with the ethical standards of the Investment Bankers Code,[26] the lack of opportunity for speculative abuse in the trading of municipal securities,[27] and the possible impairment of the municipal securities market caused by regulation or listing requirements, which might deny states and municipalities access to public borrowing.[28] These practical and policy arguments resulted in a

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Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation, 28 VAND. L. REV. 561, 582 (1975).

21. Landis, *supra* note 20, at 39.

22. The testimony of H. Thompson is illustrative: "Of course, we do not think that any security of the United States Government, for example, needs the surveillance of the Federal Trade Commission, or the security of a State Government." H.R. REP. No. 85, 73d Cong., 1st Sess. 7 (1933); *see* Note, *supra* note 20, at 582.

23. *See Hearings on S.R. 84, S.R. 56, and S.R. 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. 7037 (1934) [hereinafter cited as *Hearings*]. For a more complete discussion of this legislative history, see Note, *supra* note 20, at 583-86.

24. *Hearings*, *supra* note 23, at 7038-43.

25. *See* Note, *supra* note 20, at 584-85.

26. The Code was promulgated by the Investment Bankers of America, an organization composed of brokers and dealers of municipal securities.

27. Major purchasers of municipal securities were public institutions, insurance companies, banks, and individuals purchasing for investment. Competitive bid underwriting, little opportunity for margin purchases, and difficulty in arranging short sales also were offered as explanations for this lack of abuse.

28. *See* Note, *supra* note 20, at 585. The potential drying up of the securities market is

blanket exemption for municipal securities issuers, dealers, and other participants under the 1934 Act (except for the antifraud provisions). This exemption continued until the Securities Acts Amendments of 1975, which for the first time brought brokers and dealers within the regulatory structure of section 15 of the 1934 Act.

B. *The Securities Acts Amendments of 1975*

Primarily as a result of abusive practices by a handful of municipal securities dealers, especially "boiler room" operations,[29] along with changes in the nature and sophistication of municipal securities purchasers,[30] Congress determined that the existing antifraud rules were insufficient to protect investors from improper activities of municipal securities brokers and dealers. Thus, in the Securities Acts Amendments of 1975,[31] Congress for the first time subjected brokers and dealers, including banks, who underwrite and trade municipal securities to the comprehensive regulatory scheme of section 15 of the 1934 Act and to certain other provisions of that Act.[32]

The salient provisions of the 1975 Act affecting the municipal securities industry are the inclusion of banks among municipal securities dealers,[33] the registration requirement, including automatic membership in SIPC,[34] the application of section 15 requirements to municipal securities dealers through new section 15B,[35] the establishment of the Municipal Securities Rulemaking Board,[36] the sanctions the SEC may impose on dealers for violations of the Act or Board Rules,[37] and the provisions for consultation and cooperation among federal agencies.[38]

The 1975 Amendments allow significant self-regulation by industry members rather than mandating direct SEC regulation. They preserve the inapplicability of 1933 Act filing requirements for

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now being urged as an argument *for* regulation. *See* Part II.F. *infra*.

29. These are high-pressure selling tactics aimed at unsophisticated investors. *See, e.g.*, SEC v. Investors Associates of America, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,644 (W.D. Tenn. 1972) (complaint).

30. *See* Dikeman, *supra* note 11, at 908.

31. *See* note 8 *supra*.

32. For a careful analysis of the 1975 amendments and the emerging role of the Municipal Securities Rulemaking Board by its current chairman, see Dikeman, *supra* note 11.

33. 1934 Act § 3(a)(30), 15 U.S.C.A. § 78c(a)(3) (Supp. 1976).

34. All registered brokers and dealers under § 15(b) of the 1934 Act must belong to the Securities Investor Protection Corporation (SIPC). Securities Investor Protection Act § 3(a)(2), 15 U.S.C. § 78ccc(a)(2) (1970).

35. 1934 Act § 15B(a)(3), 15 U.S.C.A. § 78o-4(a)(2) (Supp. 1976).

36. 1934 Act § 15B(b)(1)-(2), 15 U.S.C.A. § 78o-4(b)(1)-(2) (Supp. 1976).

37. 1934 Act § 15B(c), 15 U.S.C.A. § 78o-4(c) (Supp. 1976).

38. 1934 Act § 15B(c)(6)-(7), 15 U.S.C.A. § 78o-4(c)(6)(7) (Supp. 1976).

issuers of municipal securities.[39] They ensure a continued active role by appropriate regulatory agencies: NASD, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. Perhaps most importantly for the broker-dealer industry, the 1975 Amendments proscribe Board Rules that would permit unfair discrimination between customers, issuers, brokers, or dealers, fix profits or rates of commission, or otherwise regulate beyond the purposes of the 1934 Act.[40]

Strong criticism of overregulation already has been voiced, however, concentrating on increased burdens for the small dealer, and, in one writer's view, unwarranted mandatory membership in SIPC.[41] The criticism is premature because the Board has yet to operate under its fully authorized rules and has not burdened dealers. The criticism probably is attributable to opposition to any degree of regulation in the public finance industry. It should be emphasized that the regulation is to be accomplished largely through the Municipal Securities Rulemaking Board, an independent, self-regulatory body subject only to general oversight by the SEC. The Board is composed of five members representing municipal securities brokers and dealers other than banks, five members representing municipal securities dealers that are banks or bank affiliates, and five members representing the public and not associated with any broker, dealer, or municipal securities dealer, one of whom must represent investors in municipal securities and one of whom must represent issuers.[42] This mix ensures input from many sectors and expertise in the body that is charged with drafting rules for the industry.

C. *The Impact of the 1975 Amendments*

Municipal securities dealers always have been subject to the original antifraud provisions of the 1933 and 1934 Acts,[43] but the SEC and private individuals only recently have shown great interest in utilizing these provisions against municipal securities dealers.[44]

39. *See* text accompanying note 12 *infra*.

40. *See* 1934 Act § 15B(b)(2)(C), 15 U.S.C.A. § 78o-4(b)(2)(C) (Supp. 1976).

41. *See* Chase, *Small Municipal Bond Dealers Seem Burdened by New SEC Regulations*, THE DAILY BOND BUYER, Nov. 10, 1975.

42. *See* 1934 Act § 15B(b)(1), 15 U.S.C.A. § 78o-4(b)(1) (Supp. 1976); Dikeman, *supra* note 11, at 910-11.

43. *See* note 14 *supra* and accompanying text. They also have been subject to liability under applicable state laws. *See, e.g.*, Tennessee Municipal Securities Act of 1972, TENN. CODE ANN. §§ 9-1420, -1421 (1973 Repl. Vol.); repealed by Tennessee Public Acts, ch. 506 (1976); note 214 *infra*.

44. The first SEC action was in 1967, in Walston & Co., SEC Exchange Act Release No. 8165 (Sept. 22, 1967). *See* note 5 *supra*. For a comprehensive discussion of cases involving

The reaction of the underwriting community to this increased antifraud scrutiny by the SEC and increased regulations under the 1975 Amendments to the 1934 Act has been to demand increased disclosure by issuers of municipal securities. Brokers and dealers feel they are now exposed to greater potential liability for fraud and greater possibility of SEC sanctions for misconduct that may originate not with the dealer, but with the issuer. Mr. Merrill Ring, Vice President of Bank of America NT & SA, recently expressed concern over the expanded role imposed upon municipal securities dealers:

> Whereas the analyst formerly prepared his recommendations with sole eye to their logic and his reputation, the first concerns today must be to the prospective liability of his firm and the defensibility of his position. The research report, in sum, together with the bond offering circular, have become proxies for a legal brief, prepared on the one hand by unlicensed lawyers and supervised on the other by ersatz attorney-analysts.[45]

Mr. Ring and others who deal in municipal securities are concerned primarily with the subjection of municipal securities dealers[46] to section 15(c), which prohibits the use of any manipulative, deceptive, or other fraudulent device by a dealer to effect or attempt to effect any transaction in municipal securities.[47] In addition, mu-

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underwriters and counsel in municipal securities and other exempt offerings, see Doty, *Antifraud, supra* note 5.

45. Ring, *Full Disclosure: State Agencies Should Assist in Supplying It*, THE DAILY BOND BUYER, Jan. 27, 1976 at 6, 7.

46. "Municipal securities dealer," as defined in 1934 Act § 3(a)(30), 15 U.S.C.A. § 78c(a)(30) (Supp. 1976), means:

> any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise, but does not include—
>
> (A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; or
>
> (B) a bank, unless the bank is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise: Provided, however, That if the bank is engaged in such business through a separately identifiable department or division (as defined by the Municipal Securities Rulemaking Board in accordance with Section 15B(b)(2)(H) of this title), the department or division and not the bank itself shall be deemed to be the municipal securities dealer.

"Municipal securities broker," as defined in 1934 Act § 3(a)(31), 15 U.S.C.A. § 78c(a)(31) (Supp. 1976), means:

> a broker engaged in the business of effecting transactions in municipal securities for the account of others.

"Brokers" and "dealers," as defined in 1934 Act § 3(a)(4)-(5), 15 U.S.C. § 78c(a)(4)-(5) (1970), also are subject to §§ 15, 15A & 17A of that Act, 15 U.S.C.A. §§ 78o, 78o-3, 78q-1 (Supp. 1976), since municipal securities are no longer "exempted securities" for purposes of those sections. 1934 Act § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970).

47. 1934 Act § 15(c)(1)-(2), 15 U.S.C. § 78o(c)(1)-(2) (1970).

nicipal securities dealers are expressly forbidden to effect any transaction in contravention of any rule of the Municipal Securities Rulemaking Board,[48] which is empowered to promulgate proposals for rules on the prevention of fraudulent and manipulative acts and practices.[49]

Under the amended 1934 Act, a municipal securities dealer clearly could be liable to an investor who suffered a loss from a municipal security he purchased, in the event of a material misstatement or omission in the offering circular[50] that accompanied the issue. The issuer, however, may be immune from liability under principles of sovereign immunity,[51] thus throwing the entire burden of liability on the underwriter or dealer. It is no answer to this circumstance to say that such a problem has existed since 1934. The point is that the municipal securities dealers now *perceive* this exposure, and the increased attention Congress and the SEC have focused on the subject verifies the dealers' concern. This perceived exposure or at least the current uncertainty over the responsibility of an underwriter for disclosure in connection with the sale of municipal securities[52] has caused underwriters to pass on traditional commitments and on formerly biddable issues.[53]

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48. 1934 Act § 15B(c)(1), 15 U.S.C.A. § 78o-4(c)(1) (Supp. 1976).

49. 1934 Act § 15B(b)(2), 15 U.S.C.A. § 78o-4(b)(2) (Supp. 1976) states in part:

> (2) The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers. . . . The rules of the Board, as a minimun, shall:
>
> . . . .
>
> (C) be designed to prevent fraudulent and manipulative acts and practices. . . .

Chairman Dikeman provides a listing of rules in effect, published for comment, presently filed with the SEC, under active consideration by the MSRB, or to be considered in the near future. *See* Dikeman, *supra* note 11, at 927-28.

50. "Official statement," "disclosure document," "offering circular," and "distribution statement" are terms used in various guidelines, acts, and bills to mean the basic equivalent to a prospectus.

51. *See* Part IV. *infra*.

52. The importance of this perceived increased exposure is emphasized by Mr. Donald R. Hodgman, Esq., a frequent and respected commentator in the field. *See* Hodgman Statement, *infra* note 152 at 11; Peterson & Doty, *Regulation of the Municipal Securities Market and Its Relationship to the Government Issuer*, MFOA ANALYSIS, Dec. 5, 1975; Ring, *supra* note 45; *Richmond, Va. Offer Fails to Lure Bids As Dealers React to New Disclosure Rules*, Wall Street J., Dec. 11, 1975, at 30, col. 1 [hereinafter cited as *Richmond*]; *New York State Issue Is Rejected Again by Public Lenders*, Wall Street J., Apr. 7, 1976, at 23, col. 1.

53. The large majority of municipal securities are underwritten through the competitive bidding process. For example, during 1975, approximately 79% of the offerings were competitively bid. The laws of many states require this process, and even in states where negotiated sales are permitted, that method usually is confined to revenue bond-type offerings and to small, infrequent issuers in the market. The practice in a competitive bid underwriting is for the issuer to prepare the offering statements, perhaps with the aid of a fiscal agent, but

The consequence of this reaction in the underwriting community has been forced disclosure by issuers, with the attendant expenditure of time and money, because without adequte disclosure, these issuers could not interest underwriters in their offerings. Participants in the public finance industry, however, have disagreed over the amount of disclosure that is thought to be adequate. The recent experience of Richmond, Virginia, is a good example. Richmond attempted to comply with underwriters' demands for fuller disclosure by providing each of them with a thirty-page prospectus containing fiscal data, financial reports, demographic studies, and other information.[54] Nevertheless, Richmond could not attract bids on a $25 million bond offering from underwriters who traditionally have competed for the AA-rated bonds.[55]

Other effects of the demand for fuller disclosure can be seen in bond ratings,[56] interest rates,[57] independent studies undertaken,[58] the Municipal Finance Officers Association's *Disclosure Guidelines*

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without participation by underwriters. The underwriters, or syndicates of underwriters may be bidding on many issues at one time, of which they may win the underwriting on only 25% of the issues bid. Moreover, there may be 6 or more bidders for one issue. In addition, underwriters generally are informed about the financial and political status and trends in a municipality, which may be more valuable than their participation in drafting the official statement, especially in general obligation bond offerings. The time pressures of competitive bidding, the volume of issues to which the underwriters may be exposed, the low success rate, the relative safety of municipal securities, and the inaccessibility of much information about the issuer all have contributed to limiting investigations and direct participation in the disclosure document preparation by underwriters. *See* SIA Statement, *infra* note 152; DBA Statement, *infra* note 152. For a discussion of underwriter liability in competitive bidding, see note 164 *infra*.

54. *Richmond, supra* note 53. Two months later, however, after the New York crisis had eased, Richmond was able to sell the bonds at a reduced interest rate. *See Drop in Interest Rates Sparks a Return to Bond Market by Many Municipalities*, Wall Street J., June 25, 1976, at 24, col. 1.

55. *Id.*

56. The rating houses now demand more disclosure before they will rate an issue. *See* Standard & Poor's Statement, *infra* note 152; Moody's Statement, *infra* note 152; *Nashville, Others Take Advantage of NYC's Faults*, The Tennessean, Feb. 8, 1976, § B at 2, col. 3, & 6, col. 4.

57. Issues accompanied by ample disclosure have been marketed successfully at lower interest rates than those with less disclosure. *See Tightening the Bonds*, FORBES, Mar. 1, 1976, at 22-23.

58. For example, the Municipal Finance Study Group of the Municipal Finance Officers Association has been conducting a study, under a National Science Foundation Grant, entitled *Reporting, Evaluating and Improving Municipal Credit Condition*, initial results from which are included in MFOA Statement, *infra* note 152. Also, the international accounting firm of Coopers & Lybrand, with assistance from the University of Michigan School of Business Administration, in January 1976, began a survey of the pension plan reporting in 50 of the 64 cities in the United States with populations over 200,000. The results of the survey have been generally unfavorable from the standpoint of full disclosure. *Pension Plan Reporting Criticized*, The Tennessean, May 4, 1976, at 13, col. 1.

for Offerings of Securities by State and Local Governments,[59] studies on the subject conducted in conjunction with the Practicing Law Institute's *Municipal Bond Workshop*,[60] a special "Briefing Conference" sponsored by the New York Law Journal on the subject,[61] an ALI-ABA Course of Study on the topic,[62] and, of course, the legislation now pending in Congress.[63] Perhaps the best indicator of the great concern over disclosure and its regulation is the large and careful input from all sectors of the public finance industry and its regulators in connection with the *Hearings on S. 2574 and S. 2969 of the Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities*, conducted on February 24 through 26, 1976.[64] This great interest is not attributable to the plight of the municipal securities underwriters alone, however. The furor over disclosure that now rages is properly credited in large measure to another event—the New York City crisis.

D. *The New York City Crisis*

The near-default of New York City bathed the issue of disclosure in the municipal securities industry in political light. No longer would the careful study of the Municipal Securities Study Group[65] or the Disclosure Guidelines of the Municipal Finance Officers Association[66] suffice as approaches to the dilemma. With the New York City crisis and the issue of federal aid came the inevitable call for federal regulation of disclosure. To get some flavor for this political grist, one need only read the comments of Senator Eagleton when he introduced his hastily drafted bill to subject state and local issuers to the full panoply of the 1933 and 1934 Acts:

> Mr. President, by next Thursday, as I understand it, New York City would face almost certain bankruptcy if the bill before us [federal aid for New York City] were not to pass. It appears that a major catastrophe is to be averted with only a matter of hours to spare.
>
> Did this situation arise so quickly, without warning, that no action could have been taken in advance of the ultimate crisis? I am not speaking of the months since the bond market closed to New York City, for by that time the damage had been done.

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59. *See* note 84 *infra*; Part III *infra*.
60. PLI, MUN. BONDS WORKSHOP No. 12 (1976).
61. The New York Law Journal sponsored a Briefing Conference on Disclosure in Offerings of Municipal Securities, June 7-8, 1976, and June 14-15, 1976.
62. An ALI-ABA Course of Study on Municipal Securities Disclosure Requirements for Underwriters and Issuers was conducted on May 27-29, 1976.
63. *See* Part III.B. *infra*.
64. *See* Part III.C. *infra*.
65. *See* note 58 *supra*.
66. *See* note 59 *supra* and accompanying text.

> Where were we 5, 10, a dozen years ago, when the problems were just beginning? I will tell you: We were in the dark. We did not know what was going on.
>
> Mr. President, that is an intolerable situation. The fact of this bill before us now is all the evidence anyone should need.
>
> The banks, the city officials, the bond rating services, the union leaders—many had some knowledge long ago that all was not well in New York City. But they all just went along, perpetuating the fiction of fiscal soundness, until the house of cards collapsed.
>
> There is an urgent need for legislation to open up and clean up the books of our cities and States. Only then can we assess the magnitude of the problems and develop measures to resolve them in an orderly and deliberate manner, well in advance of a major crisis.[67]

Of course, it is logical that a crisis the magnitude of the near-default of New York City, following the actual default of the New York State Urban Development Corporation, and publicity about the financial woes of other municipalities should trigger public, professional, and political reaction. Overreaction and wholesale condemnation of the municipal securities industry should be avoided, however, according to many observers and commentators.[68] Unfortunately, public reaction cannot easily be quelled, and the public reaction in this case was to doubt the credit risk of municipal securities for the first time in many years.[69] Thus, greatly increased investor demand for disclosure as well as heightened political demand for regulation of disclosure have been responses to the New York City crisis. With these demands have arisen concomitant problems of identifying who is responsible for the disclosure, how much disclosure there should be, and how the information disclosed will get to the investor.[70]

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67. 121 CONG. REC. No. 179 (daily ed. Dec. 5, 1975).

68. In his statement on behalf of the National League of Cities submitted before the Senate Subcommittee, *infra* note 152, Mayor Richard Carver of Peoria, Illinois reiterated the League Board of Director's policy statement regarding the New York City crisis:

> Congress and the Administration should be prepared to assist a municipality to obtain needed credit during a financial emergency only if it is apparent that the municipality and its state government have exhausted all constitutional, legal and fiscal remedies available under their respective authorities. Assistance measures which may be appropriate in a financial emergency, should not be made a permanent feature of federal policy with regard to municipal bond financing.

NLC Statement, *infra* note 152, at 3. *See* Doty, *The Case for Self-Regulation in Tax-Exempt Bond Financing*, THE DAILY BOND BUYER, Jan. 29, 1976, at 1, 18 [hereinafter cited as Doty, *The Case for Self-Regulation*].

69. *See* MFOA Statement, *infra* note 152, at 11-12; Hodgman, *Municipal Issuer Has Escaped Disclosure Laws by Accident*, THE DAILY BOND BUYER, MFOA SUPPLEMENT, May 19, 1975, at 3, 22-23 (discussing the Urban Development Corporation).

70. *Id.* at 12; *see* Chubb Statement, *infra* note 152.

E. *Changes in the Municipal Securities Market*

The nature of the municipal securities market has changed dramatically since the blanket exemptions for municipal securities were granted in 1933 and 1934. These changes provide much of the rationale behind arguments for increased regulation of the public finance industry. Perhaps the most startling change is in the volume of municipal securities issued. Total expenditures by state and local governments were roughly $7 billion in 1933.[71] In 1975 expenditures exceeded $200 billion, and some $60 billion in long- and short-term municipal securities were issued.[72] At the end of 1974, approximately $207 billion in publicly held indebtedness were outstanding, issued by 78,268 state and local government bodies and instrumentalities.[73] As important as the raw figures is the dramatic increase in the share of the total securities market occupied by municipal bonds. In 1974, $22.8 billion in long-term municipal bonds were issued, while $26.4 billion in corporate securities—common and preferred stock and debt—were registered with the SEC.[74] In 1975, there were 8,080 municipal securities offerings totalling $58.2 billion, as compared with 844 corporate offerings totalling $46.7 billion.[75]

Not only have the dimensions of the municipal securities market expanded greatly, but the nature of the investor has changed. Whereas formerly the principal investors in municipal securities were institutions—banks and fire and casualty insurance companies—and individuals in extremely high tax brackets, all of whom could fend for themselves, by 1975 this composition had changed. Presently, many more individuals invest in municipal bonds because of the larger number of investors who come within tax brackets that result in an attractive yield for them.[76] These investors presumably are less sophisticated and less financially able to bear the risk of loss and thus, argue some, need the protection of some form of regulation.[77]

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71. In 1976, such expenditures will exceed $200 billion. Arthur Andersen Statement, *infra* note 152, at 3.

72. THE DAILY BOND BUYER, Mar. 2, 1976.

73. SIA Statement, *infra* note 152, at 10.

74. 122 CONG. REC. S1633 (daily ed. Feb. 17, 1976).

75. *A Decade of Municipal Bond Financing*, THE DAILY BOND BUYER, Jan. 7, 1976, at 5.

76. *See* Hills Statement, *infra* note 152, at 3; Dikeman, *supra* note 11, at 908. In addition, the growth of tax-exempt funds has enabled investors to purchase municipal securities "units" for a minimum outlay of only $1,000, instead of the normal $5,000 minimum bond purchase.

77. Yeo Statement, *infra* note 152, at 3. An interesting corallary to this need to protect individuals is suggested by Mr. Harvey Kapnick, president of Arthur Andersen & Co. Mr.

Not only has the nature of the investor changed, but the types of issuers have increased in number and diversity. Issuers now include state agencies, state and municipal authorities, large cities, small towns, commissions, and public corporations. Thus, financings are complicated, comparisons difficult, and information hard to obtain.[78] Furthermore, the kinds of securities that may be offered by an issuer are varied. There are four basic types of long-term municipal securities:

1. *General obligation bonds*, backed by the "full faith and credit" of the issuing government, and normally retired from general tax revenues, and if not, mandatorily refinanced at maturity through the sale of additional bonds;
2. *Special tax bonds*, limited in security to a particular tax used to retire them (for example, highway bonds retired from gasoline taxes);
3. *Revenue bonds*, secured only by revenues that will come from investment of the proceeds (including industrial revenue bonds issued to construct a facility for a private user, the bonds to be retired from rentals paid by the user to the issuer);[79]
4. *Housing Authority bonds*, issued by a state authority with no taxing power and without a state guarantee, but secured by mortgage payments or rentals and the credit of the federal government.[80]

To that list may be added hybrid forms, such as moral obligation bonds, which are unsecured beyond specified taxes or revenues, but accompanied by the pledge of the state that they will be paid—primarily a ploy to enhance marketability.[81] Additionally,

Kapnick points out that the increased amount of municipal securities held by commercial banks raises an additional need for safety. *See* Arthur Andersen Statement, *infra* note 152, at 5-6.

78. *See* Yeo Statement, *infra* note 152.

79. Pollution control bonds currently are excepted from the general elimination of tax-exempt industrial development bonds. INT. REV. CODE OF 1954, § 103(c)(4)(F); Treas. Reg. § 1.103-8(g) (1972); Rev. Rul. 73-433, 1973 INT. REV. BULL. No. 43, at 7. Commentators have urged that pollution control bonds should no longer be classed as municipal securities and given tax-exempt treatment. *See* Doty, *Antifraud*, *supra* note 4, at 399-401; Fortune, *Special Report—The Municipal Bond Market: The Need for Reform*, 4 TAX ANAL. & ADVOCATES, TAX NOTES No. 13, at 3, 6; Peterson, *The Pollution Control Bond: A Costly Subsidy*, 4 TAX ANAL. & ADVOCATES, TAX NOTES No. 13, at 16-21.

80. Arthur Andersen Statement, *infra* note 152, at 4.

81. Moral obligation bonds were conceived in the early 1960's with the New York State Housing Finance Agency. New York State has issued most of the outstanding moral obligation bonds, but at least fifteen other states and Puerto Rico have issued some form of this security. Nuveen Report, Moral Obligation Bonds, Aug. 1, 1975, at 19-23. New York has

there are three basic types of short-term municipals:

1. *Revenue anticipation notes*, issued to obtain capital immediately in anticipation of revenues to be received in the near future and retired when the revenues come in;[82]
2. *Bond anticipation notes*, issued in anticipation of bond sales to economize on financing costs;
3. *Emergency issues*, to cover fioods, etc. not foreseen when the budget was prepared.[83]

Finally, it should be remembered that the various types of securities, from many different kinds of issuers, may be used for myriad purposes, and each separate circumstance calls for specific disclosure and materiality requirements.[84]

F. Conflict Over Issuer Disclosure

Notwithstanding the increased size, scope, and complexity of the municipal securities market, the argument for federally regulated disclosure by issuers probably would not have arisen but for the impact of the Securities Acts Amendments of 1975 and the New York City crisis with its resulting lack in investor confidence in the market. This has led to investors' demands for more information, which has aggravated the problem of underwriters' sensitivity toward their perceived exposure to liability since the 1975 Amendments. This sensitivity in turn has caused brokers and dealers to pressure issuers for expanded disclosure. Consequently, investors, politicians, academicians, and regulators, alerted by the New York crisis and aware of deleterious implications for the municipal securities market if investor confidence is lost, all began to search for solutions to the problem. An obvious solution for those who favor expanded federal regulatory authority in general was to bring municipal securities within the ambit of the federal securities laws. That approach meshes nicely with the taxable bond option[85] and

ended moral obligation borrowing by legislative enactment. Wall Street J., Mar. 16, 1976, at 27, col. 6.

82. Tax Anticipation Notes are an analogous form of short-term municipal security. See MFOA Statement, *infra* note 152, Appendix A, at 12.

83. Arthur Andersen Statement, *infra* note 152, at 4.

84. *See* Municipal Finance Officers Association, Disclosure Guidelines for Offerings of Securities by State and Local Governments, Nov. 10, 1975 [hereinafter cited as MFOA Guidelines]. A copy of the Guidelines may be obtained by writing to the MFOA at 1313 East 60th St., Chicago, Illinois 60637. The cost is $1.50.

85. This form of security has been urged as a means of relieving pressure on the municipal securities market. It would replace the interest savings that tax exemption allows with a direct federal subsidy. *See* Fortune, *supra* note 79, at 3-7.

federal financing efforts like URBANK.[86]

Others, however, oppose federal regulation. In support of their position they point to the relatively clean record of municipal securities[87] and the continued sophistication of investors.[88] They emphasize the lack of federal expertise in local finance,[89] the costs of federally imposed disclosure requirements,[90] and the substantial information available through the normal political process, sunshine laws, and press coverage.[91] Those who oppose federal regulation raise considerations of comity and intergovernmental relations that militate against federal intervention in state and local financings.[92] They also note constitutional questions regarding the extent to which the federal government may regulate state and local governments, the eleventh amendment grant of state immunity to private suit, and the common-law doctrine of sovereign immunity that may limit the exposure of state and local governments to liability.[93] Other arguments against federal intervention include the lack of motive for fraud among issuers of municipal securities and the existing state regulation of state and municipal financing.[94] Finally, opponents of federal regulation point to substantial efforts by private professional groups to bring about uniformity and full disclosure through nongovernmental standards and guidelines.

III. Efforts to Achieve Uniformity in Municipal Securities Disclosure

A. *Municipal Finance Officers Association Disclosure Guidelines for Offerings of Securities by State and Local Governments*

(1) The Guidelines

To assist in satisfying what its drafters perceived as "increased needs for investor information and the increased concern of issuers

86. The federally operated Urban Development Bank is another scheme that would replace tax exempt bond sales to the public by buying up municipal issues at their current low interest rates, and selling URBANK securities at higher interest rates to the public; the difference is made up by federal funding of URBANK. *See id.*

87. *See* 122 Cong. Rec. S1633 (daily ed. Feb. 17, 1976).

88. *See* NLC Statement, *infra* note 152, at 7.

89. *See id.* at 8. This problem is exacerhated by the extreme diversity in issues and issuers which calls for varying disclosure patterns. *See* note 78 *supra* and accompanying text.

90. *See* NLC Statement, *infra* note 152, at 8; MFOA Statement, *infra* note 152, at 13.

91. *See* NLC Statement, *infra* note 152, at 5.

92. *See* Doty, *The Case for Self-Regulation, supra* note 68, at 18; text accompanying note 21 *supra.*

93. *See* Part IV *infra.*

94. *See* Doty, *The Case for Self-Regulation, supra* note 68, at 18.

as to achieving compliance with the antifraud requirements of the Federal securities laws,"[95] the Municipal Finance Officers Association (MFOA)[96] sponsored a project to prepare suggested guidelines for informational documents used in municipal securities offerings. A cross-section of participants in the municipal securities industry provided input that resulted in the November 10, 1975, exposure draft entitled *Disclosure Guidelines for Offerings of Securities by State and Local Governments*.[97] The MFOA noted in the draft that the proposed guidelines are not intended to be legally binding, but rather are suggestions of information that "usually should be included in official statements because it will be relevant to investors on most occasions for most issuers."[98]

In their "Analysis" entitled *Regulation of the Municipal Securities Market and Its Relationship to the Governmental Issuer*, which discusses the MFOA Guidelines, John E. Peterson and Robert W. Doty, principal spokesmen of the MFOA, emphasized that the MFOA Guidelines are not an exhaustive list of disclosure items because of the ambiguity of "materiality" under the securities laws and because of the myriad forms that a municipal issue can have—each of which may have particular characteristics that are material solely to that type of issue.[99] The MFOA Guidelines adopt the *Affiliated Ute Citizens v. United States* concept of materiality[100] as their guide and caution that the antifraud provisions of the securities acts have been held to protect "speculators and charists" as well as conservative investors.[101] Thus, the MFOA Guidelines conclude:

> Consequently, the requirement of full disclosure of material information means a considerable amount of information must be disclosed to prevent liability of parties involved in an offering and to prevent the possibility of injunctions or other legal remedies which may arise as a result of violations of these provisions. In addition to civil remedies for violation of the federal antifraud provisions, Section 24 of the Securities Act of 1933 and Section 32 of

95. MFOA Guidelines, *supra* note 84, at Introduction.

96. The Municipal Finance Officers Association is an organization of finance officers from cities, counties, and other issuers of municipal securities.

97. MFOA Guidelines, *supra* note 84.

98. *Id.* at Introduction.

99. Peterson & Doty, *supra* note 53, at 3. For an excellent discussion of the varying informational requirements for "materiality" tests in different types of bond issues, see Ring, *supra* note 45.

100. 406 U.S. 128, 153-54 (1972). "'Material' information includes all information which 'a reasonable investor *might* [consider] important in the making of [a] decision.'" Quoted in MFOA Guidelines *supra* note 84, at Appendix B.

101. MFOA Guidelines, *supra* note 84, at Appendix B, citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

the Securities Exchange Act of 1934 provide for criminal penalties in the event of a "willful" violation of any of the provisions, including the anti-fraud provisions, contained in those Acts.[102]

With the careful approach evidenced by the language quoted above as a backdrop, the MFOA Guidelines outline a comprehensive system of disclosure. The Guidelines begin with a general discussion of the type of information to be included or omitted (emphasizing investor needs and varying materiality) and the appropriate manner of its presentation—concise, understandable, emphasizing the relatively important information, and properly cross-referenced. The Guidelines specify that financial and accounting information should be prepared and presented in accordance with generally accepted accounting principles as recommended by the National Committee on Governmental Accounting's *Governmental Accounting, Auditing, and Financial Reporting* (1968)[103] and the Industry Audit Guide of the Committee on Governmental Accounting and Auditing of the American Institute of Certified Public Accountants, entitled *Audits of State and Local Government Units* (1974), as these principles are supplemented and modified. The Guidelines further specify that financial statements should be accompanied by an opinion of independent certified or public accountants, or by state authorities empowered to issue equivalent opinions.[104]

Parts I[105] and II[106] of the "Suggested Disclosure" portion of the

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102. MFOA Guidelines, *supra* note 84, at Appendix B.

103. The National Committee on Governmental Accounting has been reconstituted the National Council on Governmental Accounting.

104. The need for certified financial statements is widely agreed upon. Arthur Andersen & Co., however, finds "four critical areas of deficiency" in governmental accounting practices:

1. Financial statements consolidating the funds of a governmental entity are generally not presented.
2. Accrual accounting is not followed in many cases.
3. Recognized standards of accounting for pension costs are frequently not followed.
4. Depreciable property and the related depreciation are usually not recorded.

Arthur Andersen Statement, *infra* note 152, at 7.

105. Part I suggests that disclosures include appropriate financial information selected in accordance with generally accepted accounting principles for the two most recent fiscal years for assets and liabilities, and five years for operations. Specific instructions are provided. Additionally, Part I calls for a tabular and analytical breakdown of debt and revenue structure, amounts outstanding, limits, means of valuation, funding, and other specific information.

106. Part II calls for: general information about the issuer and project, including form of government, organization of the enterprise (in revenue securities offerings); use of proceeds to the issuer; a narrative description of the issuer, including, in general obligation bond issues, ability to levy and collect taxes, trends, types of services provided, demographic information, and principal industries; a narrative description of the enterprise in revenue bond offerings, including purposes, productive capacity, estimated life, feasibility reports (financial and engineering), sources of materials, etc.; a description of property and facilities owned by the

Guidelines specify financial and general information about the issuer or enterprise and the security being offered to be provided to potential underwriters at the time bids are solicited, and passed on by the purchasing underwriter to investors. Part III,[107] in Appendix A of the Guidelines, suggests information to be furnished by the underwriter to investors at least by the time of confirmation of sale. Finally, the Guidelines state that they are not appropriate for disclosure in offerings of pollution abatement or other industrial revenue bonds, which depend for their investment risk primarily on the financial success of the private entity involved in the offering.[108]

(2) ABA Comments

In accordance with the request by the MFOA for comments on the exposure draft of the Guidelines, the ABA Subcommittee on Municipal and Governmental Obligations responded in a lengthy commentary to the MFOA.[109] The ABA comments include many specific suggestions, some of which will not be discussed here; some of the more salient opinions, however, are worth noting. The ABA feels that the Guidelines should emphasize the responsibility of the issuer for disclosure, and suggests that public officials be required to certify appropriate portions of the official statement that may provide information stated on the authority of that official. In that regard, the ABA feels that reliance on "due diligence" duties of underwriters must be avoided, and that underwriters should be able to rely on statements of public officials much as provided in section 11 of the 1933 Act with respect to underwriters' reliance on statements made by an "official person."[110]

The ABA suggests that a "Summary of Certain Financial Considerations and Risks" be included when unusual factors are present which affect the investment risk. The ABA also urges that the Guidelines recommend a postponement of bidding when it is determined that an official statement is inadequate, instead of the present solution calling for supplementary information. The comments

issuer; pending legal proceedings that may materially affect the issuer's ability to perform its obligations to the securities holders; specific information about the governing body and executive officials; a description of the securities being offered; interest of experts named in the official statement; and other information material to that particular offering.

107. Part III calls for disclosure by the underwriter of the distribution spread; plan of distribution; interest coupons, with the rates in tabular form; and the ratings of the securities.

108. The Guidelines suggest disclosure similar to Form S-1 of the 1933 Act.

109. This commentary was submitted in a letter dated Feb. 5, 1976, from Richard B. Smith, of the ABA, to the MFOA [hereinafter cited as ABA Commentary].

110. *See* 1933 Act § 11(b)(3)(D), 15 U.S.C. §77k(b)(3)(D) (1970); note 164 *infra*.

further suggest that the Guidelines "expressly recognize that particular items of disclosure with respect to municipal obligations [called for in the Guidelines] may not have been customary and that offerings should not be judged and legal liabilities cannot be appropriately predicated on their compliance or non-compliance with the Disclosure Guidelines."[111] The ABA also quarrels with the statement in the Guidelines that the amount of disclosure required decreases with the size of an issue,[112] although it agrees that not all the information called for in the Guidelines is necessarily material with respect to every issue.

The major point of departure by the ABA from the Guidelines deals with the absence from the Guidelines of a recommendation for an annual reporting system. Citing the ALI Federal Securities Code and recent commentary on trends in disclosure under the securities laws, the ABA suggests that the MFOA "place emphasis on the integration of periodic reporting and offering statements."[113] The ABA's procedure calls for preparation of a comprehensive annual report available in sufficient quantity to be used in connection with offerings during the year. The report would meet appropriate disclosure standards and would be supplemented for a particular offering by a shorter document disclosing the terms of the issue, underwriting arrangements, and any material developments that had occurred since the date of the last report. The ABA further suggests that consideration be given to having counsel who normally play a part in the offering process of an issuer participate in the preparation of the annual report and supplementary documents.

In the area of accounting, the ABA urges the MFOA to use its influence to hasten uniform adoption by the state of mandatory accounting standards (presumably based on the MCGA-AICPA generally accepted accounting principles already announced).[114] The ABA further suggests that the MFOA encourage the general use of independent accountants or that the states provide by statute for independence in governmental accounting departments.[115]

111. ABA Commentary, *supra* note 109, at 4. It is this writer's opinion that the MFOA already had adequately offered such recognition. *See* text accompanying note 98 *supra*.

112. See MFOA Guidelines, *supra* note 84, at General Instruction C., "Omission of Information."

113. ABA Commentary, *supra* note 109, at 5. The A.L.I. Federal Securities Code, now in its 5th draft, follows the integrated disclosure approach, that is, registration of the issuer through periodic reporting, supplemented by disclosure documents accompanying individual issues.

114. *See* notes 103 & 104 *supra* and accompanying text.

115. The ABA notes that this practice has been successful in Canada. ABA Commentary, *supra* note 109, at 7.

The ABA comments state that the MFOA Guidelines might more sharply distinguish between the role of counsel in ensuring adequate disclosure in a negotiated offering and in a competitive bidding. In the latter case the ABA recommends that in addition to bond counsel, additional counsel should be engaged whose primary function would be to participate in the preparation of the official statement and ensure adequate disclosure. The ABA recognizes that bond counsel also has a responsibility with regard to the adequacy of disclosure, but the ABA feels the additional professional opinion of independent counsel would aid bond counsel in this matter.[116]

The specific recommendations with respect to items in the Guidelines include: more information on trends in the issuer's finances; better means of comparative analysis as among issuers; explanatory notes to financial statements pointing out material departures from NCGA-AICPA accounting standards; more interim financial data; narrative analysis of data; specific provisions with respect to moral obligation bonds; more information on an issuer's budgetary process; legal restrictions on the use of any revenues; columnar or tabular display of the use of proceeds; and employment history of executive officials in general obligation bond offerings as well as revenue offerings. The ABA also feels that information to be supplied by underwriters is an integral part of the disclosure process and should not be set off in an appendix, as is Part III of the MFOA Guidelines. Finally, the ABA questions the propriety of the inclusion of ratings anywhere in an official statement. The ABA feels that "the policy considerations which lie at the heart of the SEC's objections to including ratings in a prospectus for issues registered under the Securities Act of 1933 [likely overemphasis placed on them by unsophisticated investors] . . . weigh decisively against inclusion of ratings."[117]

B. Congressional Proposals

(1) The Eagleton-Solarz Approach

On October 28, 1975, Senator Eagleton introduced S. 2574, a bill to amend the Securities Act of 1933 to provide for the registra-

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116. *Id.* at 7-8. It should be questioned whether such a suggestion adequately considers the expense of two or more sets of counsel, particularly for a small issuer. For an excellent discussion of the distinction between the role of bond counsel and that of counsel to an underwriter in a corporate securities offering, see Hodgman, *Municipal Issuer Has Escaped Disclosure Laws by Accident,* THE DAILY BOND BUYER, MFOA SUPPLEMENT, May 19, 1975, at 3, 20-21.

117. *Id.* at 16.

tion of securities issued by state and local governments[118] and to amend the Securities Exchange Act of 1934 to reflect the power of the SEC under the amended acts to require registration by issuers of municipal securities.[119] The same basic approach is evident in two House Bills introduced by Representative Solarz[120] that are intended to bring municipal securities within the registration and regulatory provisions of both the 1933 and the 1934 Acts. The Solarz Bills, however, are more carefully drafted than the Eagleton Bill and include amendments to additional sections of the 1933 Act[121] and the 1934 Act,[122] which are required for the bills to be at least facially consistent with the new registration requirements.

The Eagleton-Solarz approach would require issuers of municipal securities to go through the registration process just as a corporate issuer does. This approach fails to consider the uniqueness of

118. The Bill would amend §3(a)(2) of tbe 1933 Act, 15 U.S.C. § 77c(a)(2) (1970), by striking out "or any territory . . . or territories," inclusive, and "or any security which is an industrial development bond . . . does not apply to such security;" inclusive, and by adding new § 3(d):

> (d) The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed therein add to tbe securities exempted as provided in this section any class of securities issued by a State of the United States or by an political subdivision of a Stato or by any territory of the United States or political subdivision of a territory or by any public instrumentality of one or more States or territories if it finds, having regard to the purposes of this title, that the enforcement of this title with respect to such securities is not necessary in tbe public interest and for the protection of investors.

119. The Bill simply amends § 15B(d)(1) of the 1934 Act, 15 U.S.C.A. § 78o-4(d)(1) (Supp. 1976), by striking out "Neither the Commission nor the Board is" and adding in its place "The Board is not."

120. H.R. 11044 was introduced December 8, 1975, during the 1st Session by Congressman Solarz, and was referred to the House Committee on Interstate and Foreign Commerce. H.R. 11534, an identical bill, was introduced by Mr. Solarz on January 27, 1976, in the 2d Session, and was referred to tbe same committee.

121. The Bill adds new § 2(15):

> (15) The term "municipal security" means the same as the term "municipal securities" as defined in section 3(a)(29) of the Securities and Exchange Act of 1934.

It amends § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970), in tbe same way as the Eagleton Bill, *see* note 118 *supra*. It amends § 6(a), 15 U.S.C. § 77f(a) (1970), by inserting "to a municipal security or" after "except that when such registration statement relates." It amends § 7, 15 U.S.C. § 77g (1970), by inserting "a municipal security or" after "when relating to a security other than," and by inserting "to a municipal security or" after "in Schedule A, and when relating." Section 10(a), 15 U.S.C. § 77j(a) (1970), is amended by inserting "and other than a municipal security" in paragraph (1) after "other than a security issued by a foreign government or political subdivision tbereof," and by inserting "to a municipal security or" in paragraph (2) after "a prospectus relating."

122. The Bill amends § 3(a)(12), 15 U.S.C.A. § 78c(a)(12) (Supp. 1976), by inserting "12(k)" after "municipal securities sball not be deemed to be 'exempted securities' for the purposes of sections." It amends § 15B(d)(1), 15 U.S.C.A. § 78o-4(d)(1) (Supp. 1976), in the manner described in note 119 *supra* and by striking out "with the Commission or the Board" and inserting in its place "with the Board."

the municipal securities industry, the political problem of requiring registration by municipal issuers, and other conceptual difficulties.[123] Even if the Eagleton-Solarz approach had conceptual merit, which is suspect,[124] it would place an insurmountable burden on the SEC. The Commission processed 844 corporate filings in 1975; during that year there were 8,080 municipal securities offerings.[125] If the SEC currently is over-worked and understaffed and already accomplishing less than its members would like,[126] with only corporate issuers to deal with, the addition of several thousand new issues hardly seems reasonable.

Conceptually, the Eagleton-Solarz approach is open to criticism because it calls for intimate federal involvement, through the SEC, in state and local financial affairs.[127] Subjecting state and local issuers to pre-filing review by the SEC and direct federal regulation raises constitutional questions and violates concepts of comity and federalism.[128] Moreover, such requirements would place a substantial financial burden on local governments, attributable to information-gathering and compilation, auditing and certification of financial statements, and increased underwriting fees, which would be assumed by the taxpayers as additional costs of borrowing or which might close the municipal market altogether to small issuers.[129] Furthermore, the SEC currently does not have the expertise required to monitor and regulate the municipal securities industry[130]—one of the reasons for and advantages of the Municipal Securities Rulemarking Board under the Securities Acts Amendments of 1975.[131]

If there is to be federal intervention in the public finance industry, the flexibility and careful consideration of rule-making by a group of industry participants would be preferable to statutory pre-

123. See notes 162-64 *infra* and accompanying text.

124. SEC Chairman Hills himself said "it is unlikely that the threatened harm to investors justifies so drastic a proposal." SEC Statement, *infra* note 152, at 5. This criticism was echoed by Undersecretary of the Treasury for Monetary Affairs Yeo. *See* Yeo Statement, *infra* note 152, at 7. In fact, nearly all those who testified during the hearings on the two Bills preferred the Williams-Tower approach to the Eagleton-Solarz approach. *See* notes 151-52 *infra* and accompanying text.

125. THE DAILY BOND BUYER, Jan. 7, 1976 at 5.

126. Address by Neal S. McCoy, Associate Director of Corporate Finance of the SEC, to the Securities Regulation class at Vanderbilt School of Law, Dec. 2, 1975.

127. Yeo Statement, *infra* note 152, at 7.

128. *See* Part IV *infra*.

129. *Accord, infra* note 152, at 7-8; MFOA Statement, *infra* note 152, at 13; SIA Statement, *infra* note 152, at 5, 6.

130. *See* SIA Statement, *infra* note 152, at 20-22.

131. *See* notes 125-26 *supra* and accompanying text.

scriptions under the 1933 and 1934 Acts.[132] One need only contemplate the specific provisions found in section 6 (Who are the directors of a city?), section 11 (Who are the directors, and how can underwriters in a negotiated bidding perform due diligence?),[133] section 15 (Who are controlling persons?), Schedule A (drafted entirely in terms of corporate securities, which require very different disclosure from municipal securities), Schedule B (applicable by neither its terms nor its content to municipal securities issuers), and the various Forms, Regulations, and Rules under the 1933 Act to see the inapplicability to municipal securities of that Act as now written, or even as proposed by the Eagleton and Solarz amendments. The simple amendment of the 1934 Act in the Eagleton-Solarz approach does nothing to rectify these conceptual and practical problems.[134] The amendment merely recognizes the authority of the SEC to compel municipal securities dealers to register under the 1933 Act. Presumably, the Eagleton-Solarz approach anticipates further SEC activity in the form of rule-making or other regulation under either Act.

(2) The Williams-Tower Bill

On February 17, 1976, Senator Williams introduced for himself and for co-sponsor, Senator Tower, a bill entitled "Municipal Securities Full Disclosure Act of 1976."[135] This Bill would amend the Securities Exchange Act of 1934, principally by adding new section 13A, "Municipal Securities Disclosure," which would require municipal securities issuers to prepare annual reports and distribution statements in specifically described manners. The Bill is "not intended to draw any regulatory parallels between municipal and corporate securities or their issuers . . . no registration is required nor is there any requirement of prefiling review by the SEC."[136] Instead, the Bill "specifies minimum standards of disclosure, . . . limits the SEC's responsibility and authority to administering the new reporting requirements. . . [and] takes congressional notice of traditional State prerogatives by encouraging more active supervision of

132. *Accord*, SIA Statement, *infra* note 152, at 20-22.

133. *See* note 164 *infra* and accompanying text.

134. Quite different problems are raised by Williams-Tower Bill. *See* notes 162-64 *infra* and accompanying text.

135. S. 2969, 98th Cong., 2d Sess. (1976). The full text of this bill is included as an Appendix to this Note.

136. 122 CONG. REC. S1632, S1634 (daily ed. Feb. 17, 1976) (statement by Senator Williams introducing the Bill).

municipal borrowings at the State level."[137]

As explained by Senator Williams,[138] the Bill would require municipal securities issuers with aggregate outstanding securities exceeding $50 million in principal to prepare annual reports[139] containing enumerated information that includes independently audited or certified financial statements (as prescribed by the SEC) and other information that the SEC might by rule require.[140] The Bill also would require reports of events of default containing information as prescribed by the SEC.[141] Neither the annual reports nor the reports of events of default would have to be filed with the SEC. The Bill also would require "distribution statements" to be prepared (but not filed with the SEC) by issuers prior to public offer or sale of municipal securities exceeding $5 million in principal.[142] The contents of the statement are specified in the Bill and would be subject to supplementation by SEC rule or regulation.[143] The

137. *Id.*

138. *See id.* at S1634-S1636.

139. New § 13A(a)(1) requires such an issuer (the SEC would promulgate the method of computing the amount of securities outstanding) to prepare for each fiscal year an annual report and reports of events of default in accordance with SEC-promulgated rules and regulations, within a time period specified hy the SEC.

140. New § 13A(a)(2) sets forth, in general categories, the information to be contained in the annual report, including; an identification and description of the issuer; information concerning any legal limitations on its debt ceiling or its taxing authority; the nature and extent of any material contingent liabilities or commitments of the issuer; the issuer's taxing authority and structure over the past 5 years; the principal governmental and other services provided or performed by the issuer, any major changes in such services for the past 10 years, and the extent to which similar or differing services are performed by overlapping governmental entities; a description of the nature and extent of federal or other assistance programs available to the issuer; and financial statements in form and detail as prescribed by the SEC, to be audited and reported on by an independent public or certified accountant in the manner prescribed by the SEC. New § 13A(a)(4) authorizes the SEC to require "similar and specific information to be included in the annual report and reports of events of default in addition to that required in § 13A(a)(2). New § 13A(e) grants the SEC authority to prescribe the forms of reports and distribution statements and the accounting methods to be followed in preparing financial statements.

141. New § 13A(a)(3) requires these reports to contain such information listed in § 13A(a)(2) as the SEC may prescribe.

142. New § 13A(b)(1) requires such an issuer, who offers or sells through a municipal securities broker (defined in § 3(a)(31) of the 1934 Act, 15 U.S.C.A. § 78c(a)(31) (Supp. 1976)), municipal securities dealer (defined in § 3(a)(30) of the 1934 Act, 15 U.S.C.A. § 78c(a)(30) (Supp. 1976)), or a bank acting as agent, to prepare a distribution statement prior to the offer or sale in accordance with SEC rules and regulations.

143. New § 13A(b)(2) specifies that this information includes such data from the annual report the SEC may prescribe, along with specific additional information about the offering, the security offered, any project or enterprise financed by a revenue security (including feasibility reports), use of proceeds, counsel's opinion of the legality of the issue, and such other "similar and specific" information as the SEC may prescribe. The SEC has discretion to authorize a statement to be constructed in a manner suited to the particular issuer and issue.

SEC also would be empowered to ensure proper dissemination of the distribution statement, including the power to establish a central repository for reports and statements prepared under this Bill.[144]

The Bill would expressly recognize and approve state supervision of municipal securities issuers by providing an exemption from the section 13A reporting requirements for an issuer that has been approved by a state authority.[145] Other exemptions would be available for transactions meeting the criteria specified in certain sections of the 1933 Act.[146] In addition, the Bill would empower the SEC to adjust the specified threshold dollar amounts,[147] assertedly in recognition of the SEC's lack of experience in administering such requirements, its general unfamiliarity with the operations of the municipal securities markets, and the absence of accurate figures specifying the type and quantity of issuers affected at any specific level.[148]

Finally, the Bill would provide a limitation on the liability of municipal securities underwriters similar to that provided by section 11(e) of the 1933 Act for corporate securities underwriters.[149] The Bill contains no specific provisions for civil liability for material misstatements or omissions, but relies on the existing general antifraud provisions of the 1934 Act. These provisions presumably would apply to issuers and to municipal securities brokers and dealers and banks acting as agents, who received copies of a distribution statement pursuant to proposed section 13A(f)(2) in connection with an underwriting.[150]

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144. New § 13A(f).

145. New § 13A(c)(1) provides that an exemption is available to issuers in those states that actively supervise local financings when the disclosure with respect to an offer or sale has been approved, after a hearing, by a state authority (other than the issuer) expressly autborized to grant such approval. *See* text accompanying note 156 *infra* for the SEC's preliminary interpretation of this exemption.

146. New § 13A(c)(2) lists these 1933 Act provisions: §§ 3(a)(9), 3(a)(10), 4(1), 4(2), 4(3), 15 U.S.C. §§ 77c(a)(9), 77c(a)(10), 77d(1), 77d(2), 77d(3), & 77d(4) (1970).

147. New § 13A(d) grants this authority if, giving due regard to such considerations as the general economic conditions, costs involved, and the nature of the distribution system, the SEC deems cbange to be appropriate in the public interest.

148. Williams Statement, *supra* note 136, at § 1636.

149. New § 13A(g) provides:

> In no event shall any underwriter . . . [unless it receives some disproportionate benefit from the issuer for underwriting] be liable in, or as a consequence of, any suit for damages in excess of the total price at which the issue was sold by it to tbe public.

150. These brokers, dealers, and banks presumably would be required to perform such reasonable investigation as is required under the antifraud provisions. *See* Williams Statement, *supra* note 136, at S1636.

C. *Hearings Conducted by the Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities*

The list of those who testified before or submitted statements to the Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities[151] includes representatives from federal, state, and local governments, underwriters, attorneys, accountants, and investors.[152] The statements submitted by these experts from all sectors of the public finance industry provide an excellent catalogue of the positions and opinions of those most closely associated with the problem of disclosure in the issuance of municipal securities. This subsection reviews in some detail the statements of SEC Commissioner Hills and the Municipal Securities Rulemaking Board, and notes the various positions of some of the other experts on the Williams-Tower Bill and disclosure in general.

(1) Statement of SEC Chairman Hills

Chairman Hills notes in his statement that legislation providing disclosure requirements for municipal securities should provide investors with adequate information and assist issuers and underwriters by eliminating possible confusion about their legal responsibilities. Chairman Hills remarked that sufficient attention had not been devoted to the latter objective to date, partly because no well-established judicial precedent exists clarifying the liability of issuers or the application of sovereign immunity under the antifraud provisions of the 1933 and 1934 Acts. The Chairman endorses the approach of the Williams-Tower Bill in his statement. He believes that the establishment of specific disclosure requirements, as in the Williams-Tower Bill,[153] would help provide valuable guidance in this

151. *Hearings on S. 2574 and S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 94th Cong., 2d Sess. (Feb. 24-26, 1976).

152. Statements were submitted by the Chairman of the SEC [SEC Statement]; the Municipal Securities Rulemaking Board [MSRB Statement]; the Undersecretary of Monetary Affairs of the Treasury Department [Yeo Statement]; the Municipal Finance Officers Association [MFOA Statement]; the Dealer Bank Association [DBA Statement]; the Securities Industry Association [SIA Statement]; the National League of Cities and United States Conference of Mayors [NLC Statement]; the National Association of Counties [NAC Statement]; Standard and Poor's Corp. [S & P Statement]; Moody's Investors Service, Inc. [Moody's Statement]; Donald R. Hodgman, Esq. [Hodgman Statement]; Donald J. Robinson, Esq. [Robinson Statement]; Richard B. Smith, Esq. [Smith Statement]; Arthur Andersen & Co. [Arthur Andersen Statement]; and Chubb Corp. [Chubb Statement]; among others.

153. *See* notes 139-44 *supra* and accompanying text. The Chairman emphasized that this Bill does not expand the existing liability of municipal issuers or the enforcement responsibility of the SEC.

area, although the nature of the required underwriter's investigation would remain undefined.[154] The statement further notes that under the Williams-Tower Bill the Municipal Securities Rulemaking Board would be able to exercise its rulemaking authority with respect to underwriters in order to ensure effective use of the information prepared by municipal issuers.

In reviewing some of the specific provisions of the Williams-Tower Bill, Chairman Hills states that as contemplated by the SEC, the exemption for securities approved by a state authority[155] "would be available to offerings the disclosure for which, in the view of the State authority, is substantially similar to the disclosure required by [proposed] section 13A."[156] The statement observes that the information to be disclosed under proposed section 13A is similar to that called for in the MFOA Disclosure Guidelines[157] and that required of foreign governments under Schedule B of the 1933 Act. The Chairman emphasizes that in cases in which the proposed section 13A disclosure requirements would impose a demonstrably unreasonable burden on a municipal issuer, the SEC would have authority under the Williams-Tower Bill to exempt that issuer from those requirements. In closing Chairman Hills suggests that information obtained through the Subcommittee's Hearings would be helpful in determining the threshold dollar amounts for statutory applicability, in considering issues relating to the scope of underwriter liability, and in determining "the extent to which sovereign immunity is, under current law, and should be under the proposed legislation, available to issuers of municipal securities and their associated persons, and the effect of such immunity on the duty of underwriters of any issue of municipal securities."[158]

(2) Statement of the Municipal Securities Rulemaking Board[159]

The Board concurs with the need for federal legislation that

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154. *See* note 150 *supra* and accompanying text.

155. *See* note 145 *supra* and accompanying text.

156. Hills Statement, *supra* note 152 at 8; *see* notes 139-44 *supra* and accompanying text.

157. *See* Part III.A. *supra*.

158. Hills Statement at 11; *see* Part IV *infra*.

159. The Municipal Securities Rulemaking Board (the Board) submitted a detailed and well-conceived commentary on the proposed legislation and on the disclosure issue in general to the Senate Subcommittee. Because of its interest, expertise, and current responsibility in the realm of municipal securities disclosure, the comments of the Board are especially noteworthy and therefore are discussed in detail here. The recommendations of the Board form the core of this writer's suggestions for a municipal securities disclosure scheme. *See* Part V *infra*.

addresses the fundamental issues of what information municipal securities issuers reasonably should be required to make available to investors, and what the respective disclosure responsibilities and liabilities should be for issuers, underwriters, and others involved in the process of distributing municipal securities. The Board recognizes in its statement the constructive efforts of the MFOA to establish disclosure guidelines,[160] but feels that without national standards established by Congress, the present confusion over disclosure in the municipal securities market will persist.[161] The Board lists four considerations for Congress in establishing such standards:

1. Our system of constitutional federalism, which mandates due concern for and deference to the inherent sovereign powers and privileges of the states;[162]
2. The historically stable nature of municipal securities, which suggests a need for a solution that does not place disproportionate costs and restrictions on municipal securities issuers;[163]
3. The competitive bidding system that predominates in the underwriting of municipal securities, which imposes severe constraints on an underwriter's time and access to information and results in a large volume of issues on which an underwriter may bid but on which it may get the underwriting only twenty-five percent of the time;[164]

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160. *See* Part III.A. *supra.*

161. The Board notes the inability of the present statutory framework to deal with this problem: the antifraud provisions provide inadequate guidance on the various responsibilities and potential liabilities of participants in the market, and there is substantial question about the amenability of a municipal issuer to suit under the federal securities laws. *See* notes 170-77 *infra* and acompanying text.

162. In light of this consideration the Board recommends that compliance with the disclosure guidelines by state and local governments be made voluntary. The Board would have Congress amend § 15B(d)(2) of the 1934 Act, 15 U.S.C.A. § 78o-4(d)(2) (Supp. 1976), however, to authorize the Board to require municipal securities brokers and dealers to furnish official statements to investors, provided the statement meets the committee's guidelines.

163. On that basis the Board rejects the Eagleton-Solarz approach. *See* Part III.B.(1) *supra.*

164. The competitive bidding process is explained in note 52 *supra.* Because of the constraints that process imposes, the practical volume problem, and the questionable feasibility and utility of an underwriter's investigation of a general obligation bond offering, owing to the complexity of and difficulty in determining the contributing factors to the financial well-being of a state or local government, the Board feels that the liabilities of underwriters should be limited by providing for them a defense based on the absence of reasonable grounds to believe or belief that the information furnished by the issuer contains a material misstatement or omission; thus, this defense would eliminate an underwriter's due diligence obligations. This limitation on underwriter susceptibility to liability in view of the competitive bidding process is urged by the Dealer Bank Association, *see* DBA Statement, *supra* note 152 at 11, the Securities Industry Association, *see* SIA Statement, *supra* note 152, at 15-16,

4. The necessity of an issuer's responsibility for the accuracy and completeness of information in a disclosure document that it prepares or that is derived from its own records.[165]

In light of the four considerations discussed above, the Board recommends that instead of following either the Eagleton-Solarz or the Williams-Tower approach, Congress should enact the scheme that follows. First, Congress should provide a direct role for participants in the industry in the establishment of disclosure guidelines by directing the SEC to appoint a committee to develop these guidelines, composed of representatives of municipal securities issuers, underwriters, and the public (including bond counsel, accountants, and investors) in equal proportions.[166] Secondly, Congress should not enumerate specific categories of information required in annual reports and official statements,[167] but should provide only a general directive to the committee to develop such disclosure guidelines as may be necessary and appropriate for the protection of investors consistent with the public interest. Thirdly, the committee's guidelines should provide for an independent audit of an issuer, at and for a reasonably current date and period, either by an independent public or certified accountant or by an independent governmental authority.[168] Fourthly, the guidelines should apply to all issuers, regardless of size,[169] but the committee should appropriately differ-

30-35, and Donald R. Hodgman (bond counsel and chairman of the subcommittee on disclosure problems of the ABA), *see* Hodgman Statement, *supra* note 152, at 12-13.

165. The Board would not make an issuer responsible for information derived from a source outside the issuer's control or jurisdiction, in the absence of actual knowledge or reckless disregard for the accuracy or completeness of such information. The Board also feels that officers of the issuer should not face personal liability for inaccuracies except in cases of active fraud or gross negligence amounting to fraud. *See* text accompanying note 177 *infra*. The Board feels that the often low level of compensation, the possible dampening effect of liability on the willingness of citizens to serve as public officers, the burden of such responsibility on the duties of officers, the existing state fiduciary laws and remedies, and the deterrent of liability for the issuer in the event of officers' errors all militate against the imposition of potential liability for public officers.

166. The Securities Industry Association supports the idea of an organization of issuers setting disclosure guidelines, rather than the SEC, primarily because the complexity of the guidelines require the expertise of the industry. *See* SIA Statement, *supra* note 152, at 22.

167. The Board agrees with the concept of integrated disclosure through annual reports and supplementary official statements at the occasions of offerings. *Cf.* ABA commentary on the MFOA Guidelines in text accompanying note 113 *supra*.

168. *Accord*, SIA Statement, *supra* note 152, at 21; *see* notes 114-15 *supra* and accompanying text.

169. The Board apparently recognizes the need for disclosure regardless of size, *cf.* ABA commentary on MFOA Guidelines in text accompanying note 112 *supra*, and perhaps the economic disadvantages that arguably would ensue for small, exempt issuers: investors would regard their securities as substandard. This is the position of the Dealer Bank Association,

entiate among types of issuers and issues in establishing disclosure guidelines. Fifthly, Congress should require the preparation of annual reports in accordance with appropriately classified disclosure guidelines established by the appointed committee.

The balance of the Board's statement deals with participants' respective responsibilities and liabilities in connection with the offer and sale of municipal securities. Citing the disturbing case of *Sanders v. John Nuveen & Co.*,[170] which "appears to impose a greater duty on underwriters to ascertain the reliability of information concerning an issuer [of exempt securities] than that provided for non-exempt securities under section 11 of the 1933 Act. . . . ,"[171] the Board discusses in its statement the expanding scope of liability under Rule 10b-5.[172] The Board further notes that the SEC has not clarified the relationship between the differing standards of liability in Rule 10b-5 and Rule 15c1-2[173] and that the defenses available to nonexempt issuers under section 11 of the 1933 Act are not available to exempt, municipal securities issuers. In light of these circumstances and the further complication of possible issuer immunity under the eleventh amendment or common-law sovereign immunity,[174] the Board recommends that Congress enact specific liability sections for municipal securities transactions.

The Board would have Congress enact an express cause of action for damages based on material misstatements or omissions. An issuer would be absolutely liable with respect to all information it discloses (or fails to disclose), with the exception of information furnished by an official source beyond the control or jurisdiction of the issuer. Accountants, engineers, and other experts would have a defense, similar to that found in section 11(b)(3)(B) of the 1933 Act,

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see DBA Statement *supra* note 152, at 5, and the Securities Industry Associaton, *see* SIA Statement, *supra* note 152, at 18, 37-38.

170. 524 F.2d 1064 (7th Cir. 1975), *vacated*, 96 S. Ct. 1659 (1976) (Supreme Court vacated for reconsideration in light of Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976)). The *Nuveen* case is discussed in Special Project, *The One Hundred and First Justice: An Analysis of the Opinions of Justice John Paul Stevens, Sitting as Judge on the Seventh Circuit Court of Appeals*, 29 VAND. L. REV. 125, 164-67 (1976).

171. MSRB Statement, *supra* note 152, at 13.

172. The reversal of *Hochfelder* by the Supreme Court, and its requirement of scienter for Rule 10b-5 liability in that opinion may signal a judicially imposed reversal of this expansion. *See* Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976). Further evidence of such a trend may he seen in the granting of certiorari in the *Chris-Craft* cases. *See* Piper v. Chris-Craft Indus., 96 S. Ct. 1505 (1976).

173. Rule 15c1-2 was promulgated hy the SEC under § 15(c) of the 1934 Act, 15 U.S.C. § 78o(c) (1970), and defines as fraudulent those misstatements or omissions of material fact which are made by a broker, dealer, or municipal securities dealer, *with knowledge or reasonable grounds to believe* that they are untrue or misleading.

174. *See* Part IV. *infra*.

based on reasonable grounds for believing after reasonable investigation and reasonable belief that the information they provided was true and did not omit any material fact. Underwriters would be afforded a defense similar to that found in section 11(b)(3)(D) of the 1933 Act based on a showing that the underwriter had no reasonable grounds to believe and did not believe the disclosure document contained any material misstatement or omission.[175] The Board further recommends statutory damage limits, contribution, and a statute of limitations, similar to sections 11(e), (f), and (g) and 13 of the 1933 Act.[176] In addition, the Board would have Congress enact an express cause of action for civil liability, a provision for injunctive proceedings, and criminal sanctions in cases of active fraud or gross negligence, against all persons engaged in the distribution of new municipal securities issues, including officials of the issuer involved in the preparation of official statements. Gross negligence would be based on scienter or reckless disregard for the completeness of accuracy of the information disclosed.[177] This would be substituted for the implied civil liability for fraud under Rule 10b-5. Although these provisions would help to clarify the extent of underwriter liability, a major problem remains unresolved—the impact and extent of an issuer's sovereign immunity.

IV. Sovereign Immunity

Whether a state or municipality or an instrumentality or officer of such a governmental entity is amenable to suit for violations of a federal law raises complex and unsettled questions of sovereign

175. This recognizes the impracticality of a due diligence investigation in a competitive bid underwriting. *See* note 164 *supra*. The Board recognizes that in a negotiated bid underwriting, the method often used in revenue bond offerings, the opportunity exists for a due diligence investigation and the required information is more accessible and ascertainable than in a general obligation bond offering. Thus, the Board suggests that a different liability standard for underwriters may be appropriate in a negotiated bid underwriting.

176. Section 11(e), 15 U.S.C. § 77k(e) (1970), limits damages recoverable to the difference other than depreciation between the amount paid for the security and its value (1) at the time suit was brought, (2) at the time the security was disposed of before suit, or (3) at the time of disposal after suit but before judgment (if less than (1)), and limits an underwriter's liability to the total offering price of the securities underwritten by him and distributed to the public (unless some disproportionate benefit was knowingly received by the underwriter from the issuer). A similar limitation appears in the Williams-Towers Bill. *See* note 149 *supra*. Section 11(f), 15 U.S.C. § 77k(f) (1970), provides for contribution, and section 11(g), 15 U.S.C. § 77k(g) (1970), places a damages ceiling on all recoveries equal to the price at which the security was offered to the public. The limitations of actions in § 13, 15 U.S.C. § 77m (1970), are one year after discovery of an untrue statement or omission and three years after bona fide offer or sale to the public.

177. See note 164 *supra*.

immunity. The answers to the multiple questions raised by this issue may depend on the nature of the defendant (a state or a municipality), the identity of the plaintiff (a private citizen, the United States, or a state), and the forum in which the action is brought (federal, defendant state, or plaintiff state). The resolution further may turn on whether the cause of action is expressly provided by Congress through a constitutionally sound statute and what nature of relief is sought by the plaintiff. Numerous other complexities may be added to this list, but the named problems bear most directly on the question of the amenability to suit of an issuer of municipal securities.

The sovereign immunity issue here is best approached by first considering a state issuer's amenability to suit in federal court. This consideration calls for a three-tiered analysis of sovereign immunity: common-law sovereign immunity and its lifting by congressional action and corresponding state activity; judicially recognized eleventh amendment/article III sovereign immunity from suits in federal courts; and congressional power and its exercise to cause a state expressly or impliedly to waive eleventh amendment/article III sovereign immunity. No general discussion of the development or scope of sovereign immunity will be attempted here.[178] Rather, this analysis is limited to the immunity of municipal securities issuers.

The issue of the lifting of common-law sovereign immunity by congressional regnlation seems to have been settled, at least for Justice Marshall, in *Employees v. Department of Public Health & Welfare*:[179]

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178. Sovereign immunity has been the subject of numerous writings, including C. JACOBS, THE ELEVENTH AMENDMENT AND SOVEREIGN IMMUNITY (1972): Cullison, *Interpretation of the Eleventh Amendment*, 5 HOUSTON L. REV. 1 (1967); Jaffe, *Suits Against Governments and Officers: Sovereign Immunity*, 77 HARV. L. REV. 1 (1963); Martiniak, *Hall v. Nevada: State Court Jurisdiction over Sister States v. American State Sovereign Immunity*, 63 CALIF. L. REV. 1144 (1975); Mathis, *The Eleventh Amendment: Adoption and Interpretation*, 2 GA. L. REV. 207 (1968); McCormack, *Intergovernmental Immunity and the Eleventh Amendment*, 51 N.C.L. REV. 485 (1973); Nowak, *The Scope of Congressional Power to Create Causes of Action Against State Governments and the History of the Eleventh and Fourteenth Amendments*, 75 COLUM L. REV. 1413 (1975); Special Project, *Recent Developments in Attorneys' Fees*, 29 VAND. L. REV. 682 (1976); Comment, *Federal Powers and the Eleventh Amendment: Attorneys' Fees in Private Suits Against the State*, 63 CALIF. L. REV. 1167 (1975); Comment, *Implied Waiver of a State's Eleventh Amendment Immunity*, 1974 DUKE L.J. 925; Note, *A Practical View of the Eleventh Amendment—Lower Court Interpretations and the Supreme Court's Reaction*, 61 GEO. L.J. 1473 (1973); Note, *Attorneys' Fees and the Eleventh Amendment*, 88 HARV. L. REV. 1875 (1975); Note, *Monetary Remedies Against the State in Federal Question Cases*, 68 NW. U.L. REV. 544 (1973).

179. 411 U.S. 279, 287 (1973) (Marshall, J., concurring).

> Congress having validly exercised its power under the Commerce Clause . . . , the State may not defeat this suit by retreating behind its common law shield of sovereign immunity.[180]

Justice Marshall reasoned that the states relinquished their common-law sovereign immunity to the extent they conferred sovereignty on the federal government in the Constitution, in the instant case, the power in Congress to regulate commerce.[181]

The lifting of sovereign immunity by congressional regnlation that conflicts with the exercise of immunity at least renders a state amenable to suit in state court for violating the regulation[182] (assuming jurisdiction is otherwise proper). Whether the state may be sued in federal court raises eleventh amendment/article III problems.[183] Judicial decisions recognizing eleventh amendment immunity have developed the basic rule that, absent consent by the state, "a suit by private parties seeking to impose a liability which must be paid from public funds in the state treasury is barred by the eleventh amendment."[184] This is so even when the state is not named a party to the action.[185] To avoid this general proscription, the Court in *Ex parte Young*[186] devised the fiction that conduct of a state official which is not constitutionally authorized renders that official amenable to suit in federal court. The scope of *Ex parte Young* was severely restricted, however, in *Edelman v. Jordan*, by the Court's holding that only prospective injunctive relief, accompanied by "ancillary" state expenditures, could be imposed on the state officer.[187] In denying a retroactive award of funds that would come from the state treasury, an expenditure for which the state could not budget in advance, the Court emphasized the deleterious financial

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180. *Id.* at 289.

181. *Id.* at 288-89. The majority opinion in *Employees* apparently agrees:

> [I]f *Parden* was concerned merely with the surrender of common-law sovereign immunity when the States granted Congress the power to regulate commerce, it would seem unnecessary to reach the question of waiver or consent, for Congress could subject the States to suit by their own citizens whenever it was deemed necessary or appropriate to the regulation of commerce.

Id. at 280-81 n.1.

182. Again, this is Justice Marshall's two-tiered analysis. *See id.* at 287-90.

183. The eleventh amendment applies to suits by citizens of one state against another state, and denies federal court jurisdiction over such a suit. This federal court immunity also applies through construction of article III to states sued by their own citizens. *See* Hans v. Louisiana, 134 U.S. 1 (1890); *accord,* Employees v. Department of Pub. Health & Welfare, 411 U.S. 279 (1973).

184. Edelman v. Jordan, 415 U.S. 651, 663 (1974).

185. *Id.*

186. 209 U.S. 123 (1908).

187. 415 U.S. at 665-68.

impact such an award would have on the state.[188]

The third problem—congressional regulation that calls for an express or implied waiver of eleventh amendment/article III sovereign immunity by a state engaging in the regulated activity—also was addressed in *Edelman*. The Court held:

> In deciding whether a State has waived its constitutional protection under the Eleventh Amendment, we will find waiver only where stated "by the most express language or by such overwhelming implications from the text as [will] leave no room for any other reasonable construction."[189]

In so holding, the Court distinguished *Parden v. Terminal Railway*[190] and *Employees v. Department of Public Health & Welfare*[191] by noting that both cases involved a congressional enactment that by its terms authorized suit by designated plaintiffs against a general class of defendants that "literally included" states or state instrumentalities.[192]

In *Edelman* the Court pointed out that the only federal sanction provided in the statute under which the suit was brought is future termination of funds and that "this provision by its terms does not authorize suit against anyone, and standing alone, falls far short of a waiver by a participating state of its Eleventh Amendment immunity."[193] The Court further reasoned that while it had authorized suits by one private party against another to effectuate a statutory purpose,[194] "it has never done so in the context of the Eleventh Amendment and a state defendant."[195]

In light of *Employees* and *Edelman* some tentative conclusions can be drawn with respect to the amenability of state issuers of municipal securities to suit in federal court for violations of the antifraud provisions of the securities acts. First, suits for damages, which clearly impact on the state treasury, are subject to eleventh amendment immunity.[196] The question of waiver of that immunity is complicated by the initial question of whether Congress even

188. *Id.* at 666 n.11. This reflects the important consideration of a state's fiscal integrity and its control over its instrumentalities, funds, and property in sovereign immunity decisions. *See* Comment, *Federal Powers and the Eleventh Amendment, supra* note 178, at 1193; Note, *Attorneys' Fees and the Eleventh Amendment, supra* note 178, at 1881.

189. 415 U.S. at 673.

190. 377 U.S. 184 (1964).

191. 411 U.S. 279 (1973).

192. 415 U.S. at 672.

193. *Id.* at 674.

194. The Court cited J. I. Case Co. v. Borak, 377 U.S. 426 (1964), a securities case authorizing an implied right of action under § 14(a) of the 1933 Act, 15 U.S.C. § 77n(a) (1970).

195. 415 U.S. at 674.

196. *See* notes 183-88 *supra* and accompanying text.

expressly could require waiver as a condition precedent to a state's carrying out the arguably necessary function of public borrowing to finance governmental services.[197] If Congress could require waiver, it is extremely doubtful whether the Supreme Court would extend the recognized implied rights of action of private plaintiffs against other private parties under the antifraud provisions of the securities acts[198] to suits against states.[199] The 1975 amendment of the definition of "person" under the 1934 Act to include a government or political subdivision, agency, or instrumentality of government, does not by itself constitute clear indication of congressional intent to subject states to actions in federal courts for violations of the antifraud provisions.[200] Moreover, the provisions for SEC actions against a state for violations of the securities laws militate against implying a private cause of action against a state.[201] In addition, the essential services funded through municipal securities, especially general obligation bonds, suggest that such funding may be characterized as governmental, rather than proprietary activity, requiring the clearest congressional intent to require waiver of sovereign immunity.[202] Finally, the policy argument urged by Justice Marshall in his *Edelman* dissent—that the state benefited in that case from what was essentially a contractual arrangement with the federal government[203]—is wholly absent from federal municipal securities

197. This question was decided by the Supreme Court in the context of the Fair Labor Standards Act. The Court held that Congress, under the mantle of its commerce power, could not impose federal standards controlling state spending. National League of Cities v. Usery, 44 U.S.L.W. 4974 (U.S. June 24, 1976), *rev'g* National League of Cities v. Brennan, Civ. No. 74-1812 (D.D.C. 1974); *see* Fry v. United States, 421 U.S. 542, 547 n.7 (1975) (dictum) (tenth amendment "expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system"); Note, *Attorneys' Fees and the Eleventh Amendment, supra* note 178, at 1897 n.130.

198. An implied right of action under Rule 10b-5 was recognized in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

199. *See* notes 194-95 *supra* and accompanying text.

200. *See* Employees v. Department of Pub. Health & Welfare, 411 U.S. 279 (1973), in which the Court held that although Congress had amended the Fair Labor Standards Act to include state employers within its purview, this in itself was not clear indication that Congress intended to make possible suits in federal court by a citizen of one state against another state.

201. In *Employees* the Court found the policy of the FLSA so far as the states are concerned "wholly served by allowing the delicate federal-state relationship to be managed through the Secretary of Labor." *Id.* at 286.

202. *See id.* at 284-85. This distinction has been criticized, *see id.* at 297 n.11 (Marshall, J., concurring) (Marshall prefers to view the distinction in terms of voluntariness of consent—a state cannot voluntarily consent to waiver when it has no choice but to provide services in the regulated area), and defended, *see* Nowak, *supra* note 178, at 1442-43, 1449.

203. *See* 415 U.S. at 693 (Marshall, J., dissenting).

regulation. Thus, notwithstanding the congressional authority under the commerce clause to regulate the securities markets, absent an express provision calling for state waiver of sovereign immunity, if indeed Congress may so provide, the states and their instrumentalities likely are immune from actions for damages in federal court.[204]

Other sovereign immunity problems are less troublesome. A city or county issuer does not have the same eleventh amendment status as a state and thus is amenable to suit in federal court for violations of federal statutes.[205] While these subdivisions may have common-law immunity to the extent state law is determinative of liability,[206] they are amenable to suit in federal court under the federal securities laws. It is clear that the eleventh amndment does not bar the United States or an agency of the federal government from bringing suit against a state in federal court.[207] Similarly, the eleventh amendment does not bar one state's suit against another.[208] Thus, the problem primarily concerns state amenability to suits for damages in federal court. States can successfully raise eleventh amendment/article III immunity to such suits under the existing antifraud provisions of the securities laws. Therefore, only SEC actions or injunctive actions could be maintained under current law. That leaves the plaintiff the choice of suing the state for damages

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204. In Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974) *rev'd on other grounds*, United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975), the Second Circuit held that the state issuer waived its sovereign immunity with respect to federal securities laws violations by voluntarily entering into a field under federal regulation. That decision relied entirely on Parden v. Terminal Ry., 377 U.S. 184 (1964), distinguished *Employees* on the timing of the regulation, and is clearly wrong under *Edelman v. Jordan*. *See* Yeomans v. Kentucky, 514 F.2d 993 (6th Cir.), *cert. denied*, 423 U.S. 983 (1975) (finding no waiver of eleventh amendment immunity to private suits under the securities laws); Brown v. Kentucky, 513 F.2d 333 (6th Cir.), *cert. denied*, 423 U.S. 839 (1975).

Actions for injunctive relief may be brought in federal court more easily, especially if the suit is against a state official allegedly acting beyond the scope of his statutory authority. *See* Edelman v. Jordan, 415 U.S. 651 (1974), explaining Ex parte Young, 209 U.S. 123 (1908); *cf.* Larson v. Domestic & Foreign Commerce Corp., 337 U.S. 682 (1949).

205. *See* Edelman v. Jordan, 415 U.S. 651, 667 n.12; Workman v. City of New York, 179 U.S. 552 (1900); Chicot County v. Sherwood, 148 U.S. 529 (1893).

206. *See* Broward County v. Wickam, 195 F.2d 614 (5th Cir. 1952).

207. *See* Edelman v. Jordan, 415 U.S. 651, 669-70, *upholding* Monaco v. Mississippi, 292 U.S. 313 (1934). Thus, the SEC may proceed against a state issuer in federal court.

208. *See* Rhode Island v. Massachusetts, 37 U.S. (12 Pet.) 657, 720 (1838). *But see* Moore v. Tate, 87 Tenn. 725, 11 S.W. 935 (1889) (set-off against Alabama barred by common-law sovereign immunity). In the recent case of Hall v. University of Nevada, 8 Cal. 3d 522, 503 P.2d 1363, 105 Cal. Rptr. 355 (1972), the California Supreme Court found the common-law doctrine of sovereign immunity no bar to entertaining a suit against Nevada in a California court. Personal jurisdiction was obtained by use of California's long arm statute. For a critical analysis of this case see Martiniak, *supra* note 178.

in its own courts, hoping (probably in vain) that the state court will recognize Justice Marshall's theory of waiver of common-law sovereign immunity,[209] or of relying on a long-arm statute and *Hall v. Nevada*[210] as a dubious means of bringing suit against a state in the plaintiff's state court.

V. Conclusion—A Suggested Approach

The following considerations impacting on the disclosure issue have been developed in this Note: the uniqueness of the municipal securities industry, owing to the diverse natures of the securities, the wide variety of issuers, and the particular means of marketing the securities; the special circumstances created for underwriters by the competitive bidding process; the varied roles of other participants in the distribution process—fiscal agents, bond counsel, governmental accountants; the existing state machinery for regulation and control; the practical limitations on the SEC—both in staff capacity and expertise; the need for uniformity in disclosure to prevent weakened marketability of municipal securities and restrictive bidding by underwriters; and the constraints of sovereign immunity on issuer amenability to suit for violations of disclosure duties. Each of the above affects what course should be taken on the question of disclosure by issuers of municipal securities. The salient considerations are uniqueness, the need for uniformity, notions of federalism, and sovereign immunity.

When uniformity requirements are balanced against the states' sovereign interests and the industry's uniqueness, the following approach to disclosure seems appropriate. First, the Municipal Securities Rulemaking Board proposal for a committee to establish congressionally sanctioned disclosure guidelines should be adopted. This proposal takes advantage of existing expertise, does not burden the SEC, and accounts for the varied and unique nature of the industry. Compliance with these guidelines should be voluntary so as to avoid unnecessary federal involvement in state and local finance. Even voluntary guidelines would provide needed certainty among issuers and underwriters as to their respective disclosure responsibilities.

The guidelines should encompass the integrated disclosure approach evidenced in the A.L.I. Federal Securities Code.[211] The issuer's annual report would be the principal disclosure document,

209. *See* notes 180-82 *supra* and accompanying text.
210. *See* note 208 *supra*.
211. *See* notes 113 & 167 *supra* and accompanying text.

updated when material changes in the disclosure areas occur. In addition, when an issuer prepares an offering, a particularized disclosure document geared to that type of security should be prepared. These documents, together with the annual reports, should be on file with the municipality or instrumentality that prepares them, as well as with the appropriate state office—such as the comptroller's office—to provide some centrality of access. The documents should include audited financial statements certified either by public accountants or by an authorized state accounting office, at the option of the issuer.

The states should be encouraged to take a more active role in the regulation and control of municipal securities issued by their instrumentalities and political subdivisions. Because of the state and local interests involved, state expertise, and existing state mechanisms, states should license financial advisors (fiscal agents),[212] certify financial statements when requested, and certify the disclosure documents' accuracy and their compliance with the federal disclosure guidelines. Should the sovereign immunity of states from damage suits be firmly established[213] and resultant underwriters' pressure demand issuer accountability, this latter certification might include an express waiver of sovereign immunity, at least with respect to suits in state courts. Further, the states could bear the brunt of disclosure and auditing expense for small issuers, preferably through existing state capacity.

The states have a clear interest in ensuring that proper disclosure is made. As discussed above, adequate disclosure enhances marketability, ensures normal frequency of bidding by underwriters, and protects the issuer from liability should sovereign immunity not apply. Moreover, many states already have mechanisms for regnlating state and local finance that would be readily adaptable to the function of monitoring disclosure by issuers within the state. In addition, many states have statutes that regulate municipal securities in respects other than disclosure, and some provide causes of action for fraud in the issuance of municipal securities.[214]

212. Financial advisors, or fiscal agents, play a key part in a municipal offering. The financial advisor is contractually retained by an issuer to put together an issue. Among his tasks are hiring bond counsel, advising the issuer on market conditions, preparing the disclosure document, arranging for notice of sale, contacting the rating agencies, conducting the sale at a competitive bidding, and advising the issuer on a good bid. His remuneration is in the form of a commission on the sale of the securities. He has no recognized investigatory function and should be subject to liability only for active fraud or gross negligence amounting to fraud.

213. *See* note 197 *supra* and accompanying text.

214. For example, Tennessee's Municipal Securities Act, one of the most comprehen-

An example of a successful state oversight authority often cited is the North Carolina Local Government Commission.[215] That type of authority is well suited to a state like North Carolina, which has many medium-size population centers, but no very large cities. Thus, a central authority is very useful there. In states with large cities that have greater independence in fiscal affairs like Chicago, New York, or Atlanta, a different system might be more appropriate. The city itself might be charged with certifying issues by its government and its instrumentalities. Even under that system, however, the state's role as a central repository and as a licensor of fiscal agents should be preserved.

When an issuer certifies its own issues, a conflict of interest problem might seem to arise. This would be satisfied by providing the certifying authority with sufficient independence and ultimately by the onus of liability that would fall on the state (or in some cases the city) in the event of improper disclosure. The certifying officials, too, would face liability for active fraud or gross negligence amounting to fraud. In reaction to state liability exposure, the growing practice of insuring issues[216] may spread, or the state may set aside

sive state statutes regulating the issuance of municipal securities, provides a cause of action for damages in the event of fraud, including issuer liability and liability of employees of the issuer to it for their fraudulent practices. TENN. CODE ANN. § 9-1421 (1973 Repl. Vol.). The Tennessee Act also provides for criminal sanctions. *Id.* § 9-1420. The Tennessee Municipal Securities Act has been repealed, effective September, 1976. *See* note 6 *supra*. North Carolina provides for criminal and civil liability of financial officers, governing board members, and other officers and employees of local governments for knowingly granting fraudulent approval to an issue or for issuing any written statement or document knowing it to be false. N.C. GEN. STAT. § 159-181(a) (1975 Cum. Supp.). The statute also provides for removal of officers from office. *Id.* § 159-182.

215. This Commission was established by the Local Government Finance Act of 1972, found in chapter 159 of the General Statutes of North Carolina. The Commission has nine members: the State Treasurer, State Auditor, Secretary of State, Commissioner of Revenue, all ex officio, and five appointed members, one of whom must have been a mayor or member of the governing board of a city, and one of whom must have served on a county board of commissioners. N.C. GEN. STAT. § 159-3 (1975 Cum. Supp.). The Commission must certify that the issuance of all bonds and bond anticipation notes was approved under the appropriate statute. *Id.* § 159-129 (1975 Cum. Supp.). The Commission may impound the books of a local government and assume control of its financial affairs in the event of default or other specific conditions. *Id.* § 159-81(c) (1972 Repl. Vol.). Illinois also recently has provided for some state regulation of local issues in the Assistance and Regulation of Local Government Debt Offerings Act, 85 ILL. ANN. STAT. §§ 841-48 (Cum. Supp. 1976-1977). That Act is designed to facilitate through state technical and advisory assistance the marketing of local government bonds. The Department of Local Government Affairs will, at the request of a local government, review a proposed issue, provide training of local officials, give marketing aid, and actually market the issue through the state treasurer. The Department also is empowered to require submission by local governments of statistical data on local government debt and to prepare annual reports of its technical assistance and advisory activities.

216. *See Bond-Insurance and Fund Sales Jump Due to Fears Tied to New York City Crisis*, Wall Street J., Jan. 12, 1976, at 16, col. 3-4.

a fund to provide self-insurance. The impetus for issuers diligently to undertake the recommended licensing and certification procedure would be provided, of course, by the market. Rating houses, underwriters, and investors each would provide the needed pressure, as they are doing even now, according to some commentators.[217] Thus, the role of the issuer in providing disclosure would be established by a congressionally sanctioned committee with limited SEC oversight, but the actual regulation of issuer disclosure and an individual state's distribution process would remain the province of the states.[218] This retention of control by states (or in some cases, cities) would be accompanied by expressly recognized responsibility for proper disclosure and potential liability for its absence. If necessary, marketability might even force cities and states to waive sovereign immunity.

While issuers should be regulated by the states, underwriters should face specific federal statutory liability limited in accordance with the Municipal Securities Rulemaking Board's suggestions.[219] They would be obligated, however, to ensure that the financial advisor, fiscal agent, or government finance officer who prepares the disclosure document used in the underwriting is properly licensed as described above. Additionally, underwriters should be required to ensure proper state certification of an issue. Failure to carry out these basic duties could result in liability. Otherwise, the higher degrees of culpability imposed by scienter and reckless disregard should be applied.[220] As suggested by the Municipal Securities Rulemaking Board, state officials should be liable only for active fraud. Fiscal agents should be treated in the same manner as state officials. Otherwise, their needed services would become too costly, and their primary function as experts in putting together municipal issues would become enmeshed in legal considerations beyond their expertise.[221] Other participants should have their liability expressly limited as well.[222]

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217. *See* Moody's Statement, *supra* note 152, at 5.

218. The Securities Industry Association endorses this basic approach. *See* SIA Statement, *supra* note 152, at 25. Brenton W. Harris, president of Standard & Poor's Corp., also favors state regulation. *See* S & P Statement, *supra* note 152, at 2-3.

219. *See* notes 164 & 175 *supra* and accompanying text.

220. *See* note 177 *supra* and accompanying text.

221. *See* note 212 *supra*; *cf.* text accompanying note 45 *supra*.

222. The Municipal Securities Rulemaking Board approach is adequate to achieve this. *See* notes 175-77 *supra* and accompanying text. Other recommendations by the Board that should be adopted include exemptions, damages limits, and provisions for contribution. *See* note 176 *supra* and accompanying text.

The main thrust of this suggested approach is to provide nationwide, congressionally sanctioned guidelines, while leaving the regulatory effort at the state and local level. This can be accomplished by exploiting existing expertise and capacity in both the private and the public sectors. This Note has attempted to explain why this federal-state dichotomy in function is necessary in the municipal securities industry by highlighting the unique characteristics of the industry, analyzing the sensitive problems of federalism and sovereign immunity involved, and discussing divergent positions and proposals of experts in the field. Before Congress acts, it too should undertake a careful study of these and other considerations raised by commentators and industry participants.

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* Mr. Tuke received the *Robert A. Nailling Award* for this Note in the academic year 1975-76.

APPENDIX

Municipal Securitics Full Disclosure Act of 1976, S. 2969

A bill to amend the Securities Exchange Act of 1934 to require the preparation of annual reports and distribution statements by issuers of municipal securities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Municipal Securities Full Disclosure Act of 1976."

Sec. 2. (a) Section 3(a)(12) of the Securities Exchange Act of 1934 is amended by inserting "13A," immediately after the phrase "for the purposes of sections."

(b) Section 3(a)(10) of such Act is amended by inserting "guarantee of," immediately after "receipt for,".

(c) Section 12(h) of such Act is amended by inserting "13A," immediately after "section 13,".

(d) Section 15B(d)(1) of such Act is amended by striking out "Neither the Commission nor the Board is" and inserting in lieu thereof "The Board is not," and by striking out "with the Commission of the Board" and inserting in lieu thereof "with the Board,"

(e) Such Act is further amended by inserting after section 13 the following new section:

"MUNICIPAL SECURITIES DISCLOSURE"

Sec. 13A. (a)(1) Any issuer of municipal securities which has outstanding during any portion of a fiscal year an aggregate principal amount of municipal securities exceeding $50,000,000 shall prepare for such fiscal year an annual report and reports of events of default in accordance with such rules and regulations as the Commission may prescribe as being necessary or appropriate in the public interest or for the protection of investors.

(2) The annual report required by paragraph (1) shall contain the following information, if applicable:

(A) An identification and description of the issuer of the securities outstanding;

(B) A description of any legal limitation on the incurrence of indebtedness by the issuer or the taxing authority of the issuer;

(C) A description of the issuer's debt structure, including information with respect to amounts of authorized and outstanding funded debt; estimated amount of short term debt, character of amortization provisions of funded debt, sinking fund requirements, security for debt, nature and extent of guaranteed debt, and debt service requirements;

(D) A description of the nature and extent of other material contingent liabilities or commitments of the issuer;

(E) If any payment of principal or interest on any security of the issuer or any predecessor thereof has been defaulted on, or has been postponed or delayed, within the past twenty years, a description of the date, amounts and circumstances of such event and of the terms of any succeeding arrangements thereof;

(F) A description of the issuer's tax authority and structure over the past five years including the nature of taxes levied, tax rates, property (real and personal) valuation and assessment procedures, amounts of property valuations and assessments, amounts of tax levies, amounts of tax collections and delinquent tax procedures and experience;

(G) A description of the issuer's major taxpayers;

(H) A description of the principal governmental and other services provided or performed by the issuer, the extent to which similar or differing services are performed by other governmental entities which serve the same geographic area and any major changes in such services in the last ten years;

(I) A description of the nature and extent of Federal or other assistance programs available to the issuer; and

(J) Financial statements of the issuer in such detail and form and for such periods beginning not earlier than the fifth previous fiscal year as the Commission may prescribe, which statements for any fiscal year commencing on or after December 31, 1978, shall be audited and reported on by an independent public or certified accountant in such manner as the Commission may prescribe.

(3) The reports of events of default referred to in paragraph (1) shall contain such of the information required by paragraph (2) as the Commission may by rule or regulation prescribe.

(4) The reports required by paragraph (1) shall, in addition, contain such other similar and specific information as the Commission may by rule or regulation prescribe as being necessary or appropriate in the public interest or for the protection of investors.

(b)(1) Except as provided in subsection (c), any issuer that offers or sells an issue of municipal securities, the aggregate principal amount of which exceeds $5,000,000, to or through a municipal securities broker, municipal securities dealer, or bank acting as agent, shall, prior to such offer or sale, prepare a distribution statement in accordance with such rules and regulations as the Commission may prescribe as being necessary or appropriate in the public interest or for the protection of investors.

(2) The distribution statement required by paragraph (1) shall contain such of the information pertaining to the issuer required by subsection (a)(2) as the Commission may by rule or regulation prescribe, and the following:

(A) A description of the offering, including amount to be offered, price, plan of distribution, and underwriting arrangements and compensation;

(B) A description of the security to be offered, including provisions as to security, events of default, payment of principal and interest, sinking fund, redemption, debt reserve funds, priority, legality and authorization for issue and rights of security holders to bring suit against issuers;

(C) A description of any project or enterprise of the issuer to be financed from the proceeds of revenue or special assessment securities, and any engineering or financial feasibility reports or studies on the construction and operations of the project or enterprise;

(D) A description of the intended use of the proceeds of the offering;

(E) A statement of counsel's opinion as to the legality of the issuance of the securities to be offered;

(F) A statement of the availability of the reports required by this section; and

(G) Such other similar and specific information as the Commission may by rules or regulations require as necessary or appropriate in the public interest or for the protection of investors;

except that, prior to any sale, the information specified in subparagraphs (A), (B), and (E) may be set forth in preliminary form.

(c) The provisions of subsection (b) shall not apply to an issuer solely by reason of an offer or sale of municipal securities—

(1) the disclosure with respect to which has been approved, after hearing, as adequate for the protection of investors by a State governmental authority (other than the issuer) expressly authorized by law to grant such approval, or

(2) which would meet the criteria set forth in sections 3(a)(9), 3(a)(10), 4(1), 4(2), 4(3), or 4(4) of the Securities Act of

1933 if such offer or sale were not within the scope of section 3(a)(2) thereof.

(d) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, change the minimum amounts set forth in subsections (a)(1) and (b)(1) if, giving due regard to such factors as general economic conditions, costs involved, and the nature of the distribution system for municipal securities, such change is deemed to be appropriate in the public interest.

(e) The Commission may prescribe, in regard to reports and distribution statements made pursuant to this section, the form or forms in which the required information, including the financial statements, shall be set forth, and the accounting methods to be followed in the preparation of financial statements.

(f)(1) The issuer shall make the reports required by subsection (a)(1) of this section available upon request to security holders at the issuer's expense and to others at their expense and shall give appropriate public notice of such availability.

(2) The issuer shall make the distribution statement required by subsection (b)(1) of this section available to municipal securities brokers, municipal securities dealers, and banks acting as agent for delivery to prospective purchasers in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3) The reports and distribution statements required by this section shall also be maintained by the issuer at a designated location for examination by the public in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. The Commission may also contract to establish a central repository which shall receive and maintain such reports, and may require the contractor to adhere to such rules and regulations as the Commission may prescribe in furtherance of the purposes of this section. Each person subject to the requirements of this section shall, upon the establishment of any such repository, thereafter file copies of reports and distribution statements required to be prepared by this section with the repository in accordance with such rules and regulations as the Commission finds are necessary or appropriate in the public interest.

(g) In no event shall any underwriter of an issue of municipal securities (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in, or as a consequence of, any suit for damages in excess of the total price at which the issue was sold by it to the public.

Sec. 3. The amendments made by section 2 take effect on January 1, 1977.